TAX REFORM THE ELEPHANT IN THE ROOM

2017 Federal Tax Update[1]

WIPFLi LLP

Rick J. Taylor, CPA, MST | Partner, Wipfli LLP | rtaylor@wipfli.com

Ryan Laughlin, CPA, MST, JD | Partner, Wipfli LLP | rlaughlin@wipfli.com

[1] This outline compiles and summarizes scintillating events in federal taxation occurring between November 1, 2016, and October 17, 2017 It covers the important cases, rulings, and regulations issued during the year.

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The great aim of education
is not knowledge but action.

HERBERT SPENCER

I. ACCOUNTING METHODS

Avrahami, (2017) 149 TC No. 7.

Amounts paid by married taxpayers' passthrough entities to a captive insurance company owned by the wife and to an offshore insurer that facilitated a risk-distribution program were not deductible as ordinary and necessary business expenses. The Court also found that the captive insurance company's §831(b) and §953(d) elections, to be taxed as a small insurance company and to be treated as a domestic corporation, were invalid, and that certain transfers therefore were not qualified dividends subject to preferential rates.

A taxpayer may deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." (§162(a)) Insurance premiums against fire, storm, theft, accident, or other similar losses in the case of business may be deducted as business expenses. (Regulation §1.162-1(a)) Although the Code does not define "insurance," the Supreme Court has e defined insurance as involving risk-shifting and risk-distributing. (*Helvering v. Le Gierse,* (1941, S Ct) 25 AFTR 1181, 312 US 531)

§831(a) imposes tax on the taxable income of nonlife insurance companies. Taxable income means gross income minus allowable deductions. §832(b)(1) provides that the gross income of a nonlife insurance company includes its investment and underwriting income, the latter of which §832(b)(3) defines as the premiums earned on insurance contracts less losses incurred and expenses incurred.

However, "small" nonlife insurance companies with net written premiums, or direct written premiums if greater, not in excess of certain statutory amounts in the tax year may elect under §831(b) to be taxed at regular corporate rates only on taxable investment income, instead of being taxed on both investment and underwriting income.

A captive insurance arrangement generally refers to the attempt by a taxpayer to secure the traditional benefits of insurance coverage, including tax benefits, while placing its insurance business with a corporate entity owned by or related to the taxpayer. In determining whether an arrangement involving a captive insurance company constitutes insurance, the Tax Court has found that the arrangement must involve risk shifting, risk distribution, and meet "commonly accepted notions of insurance." (*Rent-A-Center Inc.,* (2014) 142 TC 1) An attempt to combine the concept of a captive insurance company with the tax advantages under §831(b) for small insurance companies is referred to as using "microcaptives."

Benyamin and Orna Avrahami own three shopping centers and three jewelry stores. In 2007, the Avrahamis consulted with a number of tax and business advisors and ultimately decided to form a captive insurance company with the assistance of Celia Clark, an attorney who devotes a significant portion of her practice to the formation and maintenance of such insurance companies. Feedback Insurance Company, Ltd. (Feedback) was incorporated in St. Kitts in November 2007. Mrs. Avrahami was its sole shareholder as well as treasurer and bookkeeper. In 2008, Feedback made two elections-a §953(d) election to be taxed as a domestic corporation for income tax purposes (which was approved by IRS), and an election to be taxed as a small insurance company under §831(b).

In 2007 and 2008, Feedback sold property and casualty insurance policies to various entities owned by the Avrahamis and also entered into a cross insurance program to reinsure terrorism insurance for other small captive insurers through a risk-distribution pool set up by Clark for her clients.

In 2009 and 2010 (the years at issue), Feedback continued to sell policies to entities owned by the Avrahamis and to reinsure terrorism polices through one of Clark's risk distribution programs-specifically, through an insurer incorporated in January 2009 in St. Kitts called Pan American. Clark had hired an actuary during 2009 and 2010 to price the various Feedback policies for the Avrahamis' entities, which included, among other things, coverage for certain legal expenses, business risk indemnity, loss of business income, and losses caused by fraudulent or dishonest acts committed by employees. There was also a tax indemnity policy that supposedly covered all additional taxes, interest, and penalties that one of the entities might become obligated to pay as a result of an "adverse resolution" of a position taken on its tax return (with exclusions for fraud, etc.). Each year, Clark gave the actuary "target premiums" that she had in mind for the Avrahamis' policies.

Despite the formation of Feedback, the Avrahamis' entities continued to buy insurance from third-party commercial carriers and made no changes in coverage.

During the years at issue, the Avrahamis' deducted $1.1 million and $1.3 million in insurance expenses for their businesses (up from $150,000 in 2006).

No claims were filed against Feedback under any of its direct policies in 2009 or 2010, and no events took place that would trigger a claim under the terrorism reinsurance. Feedback and Pan American thus accumulated a surplus, which was used to transfer funds directly to Mrs. Avrahami and to an entity owned by the Avrahami's three children to which Mr. Avrahami had transferred approximately $800,000 prior to the years at issue. $1.5 million ultimately made it from the children-owned entity back to the Avrahamis, which they claimed were nontaxable loan repayments. (The Avrahamis conceded that the amounts distributed directly to Mrs. Avrahami should have been reported, but argued that they should be taxed as qualified dividends subject to preferential tax rates.)

On Feedback's returns for the years at issue, it indicated that it had made a §953(d) election to be treated as a domestic corporation for tax purposes. Both returns also included current-year elections to be treated and taxed as a small insurance company under §831(b). Feedback's tax returns reported total assets of almost $2.4 million at the end of 2009 and nearly $3.9 million at the end of 2010, but because of the §831(b) election it paid income tax only on its investment income-i.e., interest, but not premiums. IRS issued a notice of deficiency to Feedback questioning whether it was a valid insurance company and claiming that the premiums should be taxed as income.

IRS challenged the deductions for the premiums paid to Feedback, asserting that what Feedback sold was not insurance so the premiums were not deductible as ordinary and necessary business expenses. IRS claimed that several of Feedback's policies included uninsurable risks; that Feedback failed to distribute risk because it had an insufficient pool of insureds; that risk was not shifted because neither Feedback nor Pan American was financially capable of meeting its obligations; that the arrangements did not embody common notions of insurance; and the premiums were not determined at arm's length. And, because Feedback was not an insurance company, IRS further asserted that the funds transferred out of it that eventually ended up in the Avrahamis' bank account-whether directly or indirectly through the entity owned by their children-must be ordinary income to them.

The Avrahamis and Feedback, however, claimed that everything they did complied with the Code and relevant case law. So, they argued, Feedback is a valid insurance company that qualified and properly elected to the taxed under §831(b), all policies covered insurable risks, premiums were actuarially determined-and the deductions claimed were proper and the distributions through the children-owned entity were nontaxable loan repayments.

The Tax Court, siding with IRS, concluded that the arrangements at issue did not constitute insurance.

First, the Court found that there was no true risk distribution in this case. Feedback insured only three of the Avrahamis' entities in 2009 and four in 2010, which, under case law and IRS rulings, was too few to adequately distribute risk. In addition, the Court acknowledged that risk distribution can be achieved by the number of independent risk exposures, citing *Rent-A-Center*, (2014) 142 TC 1 (where, although few entities were involved, the captive provided workers' compensation, automobile, and general liability policies covering more than 14,000 employees, 7,100 vehicles, and 2,600 stores, and the expenses were held to be deductible), but found that Feedback's relatively small number of risk exposures were insufficient.

The Court also concluded that, in addition to the absence of risk distribution, the insurance arrangement through Feedback did not constitute insurance in the "commonly accepted sense." It dealt with claims "on an ad hoc basis," made investment decisions that "only an unthinking insurance company would make," and charged unreasonable premiums. The Court observed that the Avrahamis' entities spent approximately $1 million more in insurance during the years at issue than in preceding years, they maintained their prior commercial coverage, the premiums were determined in a manner that the Court found incomprehensible, and no claims were actually filed with Feedback until after IRS began its audit.

With respect to Pan American, the Court concluded that it was not a bona fide insurance company. The Court found that the overall effect of the arrangement was a circular flow of funds, that Pan American charged unreasonable premiums for terrorism coverage, and that, looking at the overall terms of the coverage, no reasonable business would have bought it. Notably, the probability of a claim being actually triggered was extremely low-in fact, the actuary who set the premiums could not name any event in history that would have done so-and it was also questionable whether a qualifying loss would have been paid.

Accordingly, since Feedback failed to distribute risk and was not selling insurance in the commonly accepted sense, and since Pan American was not a bona fide insurance company, the Court found that the premiums paid were not for "insurance." And, since Feedback accordingly was not an insurance company, its §831(b) and §953(d) elections were invalid, and the Avrahamis' entities could not deduct the purported premiums.

Additionally, given that the Court's determination that the §953(d) election was invalid, the funds transferred to Mrs. Avrahami were not received from a domestic or qualified foreign corporation and were thus taxable at ordinary income rates, not preferential tax rates for qualified dividend income.

The Court then found that a portion of the amounts that were paid from the entity owned by the Avrahamis' children to them that were structured to look like loan repayments were actually a taxable distribution. The Court found that there was a bona fide loan, but that the amount "repaid" significantly exceeded the loan and that the excess was a taxable distribution.

Finally, the Court partially upheld IRS's imposition of accuracy-related penalties.

Estate of Bartell, AOD 2017-06, 8/24/2017.

Action on Decision (AOD) announcing its nonacquiescence with a Tax Court decision that held that, where a taxpayer used a third-party exchange facilitator to facilitate a §1031 like-kind exchange, the fact that the facilitator held the new property for 17 months during which the taxpayer had the benefits and burdens of ownership did not cause the entire transaction to be a nonqualifying "self-exchange."

§1031 provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

The general purpose of this deferral is based on the premise that there has been no material change in the taxpayer's economic position-his investment in the new property is essentially treated as a continuation of his investment in the old property. (*Commissioner v. P.G. Lake, Inc.,* (S Ct 1958) 1 AFTR 2d 1394)

§1031(a)(3) allows deferred like-kind exchanges, which are exchanges in which replacement property is acquired after, but within 180 days of, the taxpayer's transfer of the relinquished property. Regulation §1.1031(k)-1 allows taxpayers to use qualified intermediaries and other arrangements to facilitate their deferred like-kind exchanges. Neither §1031 nor the regulations address exchanges in which the replacement property is acquired and "parked" with an accommodating party before the taxpayer's transfer of the relinquished property (a reverse exchange).

Revenue Procedure 2000-37, 2000-2 CB 308, modified by Revenue Procedure 2004-51, 2004-2 CB 294, provides a safe harbor for taxpayers seeking to park relinquished property or replacement property with an exchange accommodation titleholder (EAT) in anticipation of a like-kind exchange. If the safe harbor requirements are met, including that the EAT cannot hold the parked property for more than 180 days, the EAT (and not the exchanging taxpayer) is considered the owner of the property held by the EAT, regardless of who has the benefits and burdens of ownership. Revenue Procedure 2000-37, §3.04 provides that, in transactions in which the requirements of the revenue procedure are not satisfied, "the determination of whether the taxpayer or the exchange accommodation titleholder is the owner of the property..., and the proper treatment of any transactions entered into by or between the parties, will be made without regard to the provisions of this revenue procedure."

Revenue Procedure 2000-37 is effective for transactions entered into with respect to an EAT that acquires qualified indicia of ownership of property on or after September 15, 2000.

The taxpayer, the Estate of Bartell, was one of the owners of Bartell Drug, an S corporation. In 1999, Bartell Drug entered into an agreement to purchase the Lynnwood property from a third party. Bartell Drug approached Section 1031 Services, a corporation that provided qualified intermediary services, about the possibility of employing an exchange. By March of 2000, it had been agreed that EPC Two, a single-purpose entity formed for the exclusive purpose of acting as an exchange facilitator for Bartell Drug, and owned by an affiliate of Section 1031 Services, would take title to the Lynnwood property. EPC Two ultimately purchased the Lynnwood property on August 1, 2000, using bank financing guaranteed by Bartell Drug. Work on the new property itself began immediately (managed by Bartell Drug).

Observation: The transactions in this case took place before the effective date of Revenue Procedure 2000-37 so the safe harbor rules did not apply.

Upon substantial completion of the construction on the Lynnwood property in June 2001, Bartell Drug entered a lease agreement with EPC Two from that time until when title to the property was transferred from EPC Two to Bartell Drug on December 31, 2001.

Meanwhile, Bartell Drug was also proceeding with steps directed toward the property to be relinquished in the exchange. It acquired a retail drugstore in Everett, Washington in August of 2000 (the Everett property), then entered an agreement to sell that property in September of 2001 and use the "proceeds...to purchase our store in Lynnwood."

On December 17, 2001, Bartell Drug and Section 1031 Services executed an agreement for the exchange of the Everett property for replacement property (the Lynnwood property) in a transaction intended to qualify for tax deferred treatment under §1031. Bartell Drug assigned the Everett sale agreement to Section 1031 Services, which then transferred the relinquished property to the Everett property purchasers, acquired the replacement property from EPC Two, and transferred the replacement property to Bartell Drug. The transfers of the Everett and Lynnwood properties took place between December 26, 2001 and January 3, 2002.

Bartell Drug included with its 2001 return Form 8824, Like-Kind Exchanges, reporting that the Everett property had been acquired on August 1, 2000 and transferred to another party on December 28, 2001 and that the Lynnwood property was actually received on January 2, 2002. IRS disallowed the deferral treatment of the gain and issued deficiency notices to the Estate, which it challenged in the Tax Court.

IRS argued that Bartell Drug (rather than EPC Two) was the true owner of the replacement property during the period that its title was held by EPC Two and that therefore, Bartell Drug was considered to have engaged in a self-exchange (i.e., exchanging property with itself) that did not qualify as a tax-free like-kind exchange.

The Tax Court, in *Estate of Bartell*, (2016) 147 TC 140, found that Bartell Drug's disposition of the Everett property and acquisition of the Lynnwood property qualified for nonrecognition treatment pursuant to §1031 as a like-kind exchange. In so ruling, it held that EPC Two should be treated as the owner of Lynnwood during the period it held title to the property. The Court cited a Ninth Circuit case (the relevant Court of Appeal in the case), *Alderson v. Commissioner*, (CA 9 1963) 11 AFTR 2d 1529, as well as *Biggs v. Commissioner,* (CA 5 1980) 47 AFTR 2d 81-484, both of which "expressly rejected the proposition that a person who takes title to the replacement property for the purpose of effecting a §1031 exchange must assume the benefits and burdens of ownership in that property to satisfy the exchange requirement." Put otherwise, the Court stated that these cases "establish that where a §1031 exchange is contemplated from the outset and a third-party exchange facilitator, rather than the taxpayer, takes title to the replacement property before the exchange, the exchange facilitator need not assume the benefits and burdens of ownership of the replacement property in order to be treated as its owner for §1031 purposes before the exchange."

IRS has now announced that it does not acquiesce in the Bartell case.

It said that the case law cited by the Tax Court involves transactions that were consummated prior to the issuance of the deferred exchange regulations and Revenue Procedure 2000-37. For transactions outside the scope of the deferred exchange regulations, IRS does not follow the court opinions that take the view that, for §1031 purposes, an exchange facilitator may be treated as the owner of replacement property regardless of whether it has the benefits and burdens of ownership. Similarly, in determining whether a reverse exchange outside the scope of Revenue Procedure 2000-37 meets the requirements of §1031, IRS will not follow the principle in the court opinions that an EAT may be treated as the owner of property regardless of whether it possesses the benefits and burdens of ownership.

Under Revenue Procedure 2000-37, taxpayers are permitted to use an EAT and meet the exchange requirements of §1031 even though the taxpayer acquires the benefits and burdens of ownership of the replacement property up to 180 days before the exchange intended to qualify as a tax-deferred like-kind exchange. Taxpayers that use accommodating parties outside the scope of Revenue Procedure 2000-37 have not engaged in an exchange if the taxpayer, rather than the accommodating party, acquires the benefits and burdens of ownership of the replacement property before the taxpayer transfers the relinquished property. IRS will not follow the Tax Court's opinion in Bartell to the extent the opinion provides otherwise.

Observation: IRS's non-acquiescence does not use the term "self-exchange," but it seems clear that it is in effect arguing that when a taxpayer has the benefits and burdens of ownership before he acquires title, in circumstances like those in this case, there is a self-exchange and therefore no qualifying like-kind exchange.

BC Ranch II, L.P. v. Commissioner, (CA 5 08/11/2017) 120 AFTR 2d ¶2017-5143.

A Tax Court decision disallowing charitable deductions for certain conservation easements was vacated and remanded. The Tax Court disallowed the deductions, because: (1) the conservation easements were not given in perpetuity; and (2) the sales of the limited partnership interests were actually disguised sales of partnership property.

The taxpayer donated two conservation easements to the North American Land Trust (NALT). Both easements protected and preserved: (1) the habitat for the gold-cheeked warblers and other birds and game, (2) watershed, (3) scenic vistas, and (4) mature forest. NALT was granted perpetual rights over the areas that prohibited most residential, commercial, industrial, and agricultural uses. The easements could only be amended with NALT’s consent and then only to modify the boundaries of the homesite parcels. NALT monitors the conservation area and has repeatedly found it in compliance with the terms of the easements.

The Tax Court found that the homesite boundary modification provision in the easement violated the perpetuity requirement citing *B.V. Belk,* CA-4, 2015-1 USTC ¶50,107. However, the Tax Court’s reliance on Belk was misplaced. Unlike the easements in Belk, which could be shifted anywhere, only discrete five-acre parcels, entirely within the exterior boundaries of the easement, could have their boundaries moved. Moreover, the boundaries could only be moved with NALT’s permission, for example, to cover locations subsequently chosen as nesting sites by the warblers. Further, changing the boundaries of some of the homesite parcels would not return any value to the easement donors. The unencumbered homesite parcels had roughly the same per-acre value as the encumbered part of the ranch. Therefore, the homesite adjustment provision did not prevent the conservation easements from satisfying the perpetuity requirement and, thus, did not prevent the taxpayers from taking a charitable deduction.

In addition, the Tax Court clearly erred in holding that the baseline documentation provided by the taxpayers did not satisfy Regulation §1.170A-14(g)(5)(i). In reaching its determination, the Tax Court failed to consider significant information contained in the record including: aerial photographs, detailed maps, photographs taken by NALT’s biologist, a habitat assessment report, the NALT biologist’s report, the site plan. These documents, together with the documents the Tax Court acknowledged in its opinion, were more than sufficient to establish the condition of the property before the easement donation. Further, the Tax Court’s hypertechnical requirements for baseline documentation, if allowed to stand, would create uncertainty by imposing ambiguous and subjective standards for such documentation and were contrary to the statute’s purpose.

Further, the determination that the limited partners’ entire contributions were receipts from disguised sales was also incorrect. The fair market value of the appurtenant rights could not equal the entire amount of limited partner contributions. There were no ownership rights in the common areas. The limited partners’ rights were limited rights of use. Further, there was no evidence of the limited partners’ right to use the common areas. Without evidence of the right’s value, there was nothing to support including any specific dollar amount for a disguised sale attributable to the “appurtenant rights.” Therefore, the Tax Court’s determination that all of the partners’ contributions were disguised sales was vacated and remanded for determination of the correct amount of any taxable income resulting from the disguised sales.

Finally, the gross-valuation misstatement penalty was vacated and remanded. The Tax Court must determine whether the penalty was applicable and the proper amount of the penalty.

Vacating and remanding sub nom a Tax Court decision, 110 TCM 48, Dec. 60,348(M), TC Memo. 2015-130.

§170(h)(1)(A) provides that a qualified conservation contribution requires a contribution of a qualified real property interest. Under §170(h)(2)(C), a qualified real property interest includes a "perpetual conservation restriction," i.e., a restriction granted in perpetuity on the use which may be made of the real property interest. Regulation §1.170A-14(b)(2) provides that a perpetual conservation restriction is a restriction granted in perpetuity on the use which may be made of real property-including an easement or other interest in real property that, under state law, has attributes similar to an easement (e.g., a restrictive covenant or equitable servitude).

In *Belk,* (2013) 140 TC No. 1, the Tax Court held that a taxpayer was not entitled to claim a charitable deduction for a conservation easement because a provision in the grant allowed for potential substitution of the donated property. The Court found that this was inconsistent with Regulation §1.170A-14(b)(2)'s requirement that the conservation purpose be protected in perpetuity. In *Belk,* TC Memo 2013-154, in denying a reconsideration of its earlier decision, the Tax Court clarified that the first Belk opinion had found that §170(h)(2)(C) requires that taxpayers donate an interest in "an identifiable, specific piece of real property." In affirming the Tax Court, the Fourth Circuit held that the easement did not restrict a "defined and static parcel" of real property, and so was not a qualified real property interest. (*Belk v. Commissioner* (CA 4 12/16/2014) 114 AFTR 2d 2014-6952)

Regulation §1.170A-14(g)(5)(i) provides that, for purposes of the qualified conservation contribution rules, if the exercise of rights reserved by the donor may impair conservation interests associated with the property, the donor must make available to the donee, before making the donation, sufficient documentation to establish the property's condition at the time of the gift. This is known as the "baseline documentation" requirement. Under Regulation §1.170A-14(g)(5)(i)(D), such documentation may include: (1) survey maps showing the property line and other protected areas, (2) a map of the area showing man-made improvements, vegetation, flora and fauna (including rare species locations), (3) land use history, and distinct natural features, (4) an aerial photograph of the property taken as close as possible to the date of the donation, and (5) on-site photographs taken at appropriate locations on the property.

Between 2003 and 2005, Bosque Canyon Ranch, L.P. (BCR), a limited partnership, made $2.2 million worth of improvements to Canyon Ranch (BC Ranch), a 3,744-acre tract it owned. In 2004, BCR began marketing limited partnership units that would entitle each limited partner to a fee simple interest in an undeveloped 5-acre parcel of property (Homesite parcel). The distribution of Homesite parcels was conditioned on BCR granting the North American Land Trust (NALT), a tax-exempt organization, a conservation easement relating to 1,750 acres of BC Ranch.

On December 29, 2005, pursuant to a deed of conservation easement (2005 deed), BCR granted an easement (2005 easement) to the NALT. The 2005 deed provided that portions of the area subject to the easement included habitat of the golden-cheeked warbler, an endangered species of bird endemic to, and nesting only in, Texas. Property subject to the 2005 easement could not be used for residential, commercial, institutional, industrial, or agricultural purposes. BCR retained various rights relating to the property, including rights to raise livestock; hunt; fish; trap; cut down trees; and construct buildings, recreational facilities, skeet shooting stations, deer hunting stands, wildlife viewing towers, fences, ponds, roads, trails, and wells.

The 2005 easement provided that Homesite parcel owners and the NALT could, by mutual agreement, modify the boundaries of the Homesite parcels, provided that any such modification could not, in the NALT's reasonable judgment, directly or indirectly result in any material adverse effect on any of the conservation purposes, and the area of each Homesite parcel could not be increased (Homesite boundary modification provisions).

At BCR's direction, the NALT prepared baseline documentation relating to the 2005 easement (2005 baseline documentation). The 2005 baseline documentation, dated December 29, 2005, included: maps, a recorded copy of the 2005 deed, photographs taken in 2004, existing conditions reports, and a signed owner acknowledgement (which certified that BCR received and fully reviewed the attached baseline documentation in its entirety and that it was an accurate representation of the physical condition of the conservation area). The Site Survey Report described BC Ranch and its golden-cheeked warbler habitat. In 2007, the conservation biologist completed the report using notes that the NALT's conservation biologist took during an April 2004 visit to BC Ranch.

On its 2005 Form 1065, U.S. Return of Partnership Income, BCR claimed an $8.4 million charitable contribution deduction relating to the donation of the 2005 easement. On audit, IRS challenged this deduction.

IRS contended that the deed violated the perpetuity requirement of §170(h)(2)(C). BCR argued that the 2005 deed did not violate this requirement because: (1) any modifications to the boundaries of the Homesite parcels were subject to the NALT's reasonable judgment; (2) the exterior boundaries of the property subject to the easements could not be modified; and (3) the overall amount of property subject to the easements could not be decreased.

The Tax Court, looking to the Belk decision, concluded that the easements did not constitute a qualified real property interest and that BCR was not entitled to a deduction based on a qualified conservation charitable contribution. The Court found that, as a result of the Homesite boundary modification provisions, the property protected by the 2005 easements at the time it was granted could subsequently lose that protection and thus the restriction on the use of the property was not granted in perpetuity.

Further, the Tax Court found that BCR -which had reserved rights to conduct various activities (i.e., hunting, trapping, construction) that had the potential to impair the easements' conservation interests-failed to make available to the NALT documentation satisfying Regulation §1.170A-14(g)(5)(i) 's baseline documentation requirement. Also, the Court found that the 2005 baseline documentation was unreliable, incomplete, and insufficient to establish the condition of the property on the date the easement was granted. (*Bosque Canyon Ranch,* TC Memo 2015-130)

The majority opinion for the Court of Appeals for the Fifth Circuit, vacating and remanding the Tax Court's judgment, found that the Homesite boundary modification provisions were readily distinguishable from those in Belk and were not an adequate basis for denying a charitable deduction. Notably, the Homesite boundary modification provisions did not allow any change in the exterior boundaries of the easements or in their acreages. Rather, only the lot lines of one or more the 5-acre homesite parcels are potentially subject to change, and then only (1) within the easements and (2) with NALT's consent (which NALT had "virtually unrestricted discretion to withhold"). In contrast, the easement in Belk could effectively be lifted and moved elsewhere, and the potential for "parcel-swapping" rendered it not granted in perpetuity. (The dissenting judge agreed with the Tax Court that, as a result of the Homesite boundary modification provision, the easement did not satisfy the perpetuity requirement.)

The majority noted that the Homesite boundary modification provisions in this case reflected common sense, i.e., they reflected a need for flexibility to address changing or unforeseen conditions on the property subject to an easement (e.g., the chosen nesting locations of the warblers), and that this flexibility "clearly benefits all parties, and ultimately the flora and fauna that are their true beneficiaries." Overall, the Court found that any "potential future tweaking of the boundaries" would not detract from the easements' conservation purposes, especially given that NALT's prior approval would be required for any such change. Accordingly, the Court found that the Homesite boundary modification provisions did not preclude a charitable deduction in this case.

The Fifth Circuit also found that the Tax Court erred in concluding that the documentation made available to NALT failed to satisfy the baseline documentation requirement. The Fifth Circuit said that, in reaching its conclusion, the Tax Court failed to consider significant information contained in the record, including (1) aerial photographs and detailed maps, (2) photographs of the ranch taken by a NALT biologist on April 1, 2004, (3) the "Habitat Assessment" report prepared by Integrated Environmental Solutions (IES; which BCR hired to consult on various ecology issues and compliance with the Endangered Species Act) based on site surveys in April 2004 and December 2005, (4) photographs of the ranch taken by NALT's president in August 2003, (5) the NALT biologist's April 12, 2004 report on the presence and approximate habitat of the gold-cheeked warblers, and (6) a site plan BCR sent to NALT in September 2005 depicting the location of homesite parcels in relation to the habitat areas that IES identified. Together with the documents that the Tax Court described in its opinion, the Fifth Circuit found these documents to be "more than sufficient" to establish the condition of the property prior to the donation.

Accordingly, the case was remanded to the Tax Court. Although the Fifth Circuit vacated the Tax Court's holdings regarding the perpetuity of the easements and the baseline documentation, it remanded for the Tax Court to consider other grounds asserted by IRS to support disqualification of the easements as charitable deductions that had not been addressed by the Tax Court.

Basic Engineering, Inc., TC Memo 2017-26.

A taxpayer that disassembled, transported, and assembled oil refineries under two long-term contracts could not use the completed contract accounting method because a reasonable estimate by the taxpayer would have shown that the contracts could not have been completed within two years of the contract commencement dates, as required under §460(e)(1)(B)(i).

A "long-term contract" means any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the tax year in which such contract is entered into. (§460(f)(1)) Manufacturing contracts are generally not treated as long-term contracts, meaning the long-term contract accounting rules of §460 do not apply. (§460(f)(2)) However, if a contract involves the manufacture of (a) any unique item of a type not normally included in the finished goods inventory of the taxpayer or (b) any item which normally requires more than 12 calendar months to complete, then the contract is treated as a long-term contract and is subject to §460. (§460(f)(2)(A), §460(f)(2)(B))

Long-term contracts must generally be accounted for under the percentage-of-completion method. Under the percentage-of-completion method, contract price is reported as contract costs are incurred, based on the proportion of incurred to estimated total costs. (§460(b)(1)(A)) Under the completed contract method, contract price and costs are reported upon contract completion. (Regulation §1.460-4(d))

However, there is an exemption from using the percentage-of-completion method if certain requirements are met. One of the requirements is that the contract meets a 2-year test under which, at the time the contract was entered into, the taxpayer reasonably estimated the contract would be completed within two years of the contract commencement date. (§460(e)(1)(B)(i), Regulation §1.460-1(f)(4))

For purposes of the long-term contract rules, the contract commencement date, for any contract, is the first date on which any costs allocable to the contract are incurred, other than bidding expenses or expenses incurred in connection with negotiating the contract. (§460(g), Regulation §1.460-1(b)(7))

The primary business of Basic Engineering, Inc. (Basic Engineering) is the engineering, designing, procuring, refurbishing, and delivering of crude oil processing and refining systems to customers in the petrochemical industry worldwide. Basic Engineering entered into two sales and purchase agreements (SPAs) each for the disassembly, transportation, refurbishing, assembly, and certification of a new oil refinery: (1) a contract with Petromaxx Energy Group GmbH (Petromaxx) to build an oil refinery in Bulgaria; and (2) a contract with Amber Energy S.A. (Amber) to build an oil refinery in Pakistan. Both of these contracts normally would require more than 12 calendar months to complete.

The Petromaxx SPA was executed on October 28, 2006, but prior to that date Basic Engineering purchased a refinery (the Cenco refinery) on March 22, 2006 to be used in the Petromaxx deal. The only provision in the Petromaxx SPA that referenced a specific date was with respect to the taxpayer's delivery obligations. Basic Engineering was to "use its best efforts" to deliver the last unit by April 30, 2007, but failure to do so would not result in penalties; rather, the taxpayer would only default under the Petromaxx SPA if it failed to deliver the last unit by September 12, 2007. The Petromaxx SPA did not include terms requiring Petromaxx to ship the refurbished units from Houston, Texas, to Bulgaria by a specific date, begin or finish creating the refinery site by a specific date, or begin or finish installing and erecting the newly refurbished units into a refinery by a specific date.

While Basic Engineering had adopted 3-D laser scanning and modelling (which allowed existing refineries to be scanned before their deconstruction and produced blueprints and models of the assembled refineries) and parallel processing systems (allowing multiple stages of the refurbishing and reconstruction processes to proceed in tandem), the contract did not make reference to these processes.

The Amber SPA was executed on July 17, 2008, and shortly after that date, Basic Engineering purchased a refinery (the Atlas refinery) on July 24, 2008 to be used in the Amber deal. The Amber SPA did not specify dates by which the refinery had to be assembled, commissioned, and performance tested. There was a November 15, 2010 delivery date, but Basic Engineering contended that this was an arbitrary date selected by the parties. Basic Engineering stated that the parties intended to implement the taxpayer's parallel processing system, which would have allowed the Amber SPA to be completed within about 18 to 24 months. However, the terms of the Amber SPA did not reference the taxpayer's parallel processing system.

Basic Engineering accounted for the Petromaxx and Amber SPAs using the completed contract method. On audit, IRS determined that the taxpayer was ineligible to use this accounting method because the contracts should have been reported as a manufacturing contract and accounted for using the accrual accounting method. Alternatively, IRS determined that the taxpayer had to account for both contracts using the percentage of completion method because the taxpayer could not have estimated their completion within the 2-year period beginning on the respective contract commencement dates.

The Tax Court, rejecting IRS's primary position, determined that the Petromaxx and Amber SPAs were both for the manufacture, building, installation, or construction of property, and as neither contract was to be completed within the tax year in which it was entered into, both were long-term contracts under §460. However, the Court sustained IRS on its alternate position and found that the taxpayer had failed to reasonably estimate that the Petromaxx and Amber refinery projects could be completed within two years.

At trial, Basic Engineering did not offer into evidence any documentation reflecting dates by which the taxpayer or Petromaxx expected the taxpayer to begin or finish its obligations. Documentation, primarily the Petromaxx SPA and the testimony of IRS's expert, supported IRS's position that the taxpayer did not reasonably estimate that the Petromaxx refinery project could be completed within two years. IRS's expert testified that a 3-year time frame to complete the Petromaxx project was "optimistic but possible." Although the taxpayer's expert noted that IRS's estimate was based on traditional methods, rather than the use of 3-D laser scanning, modelling, and parallel processing, Basic Engineering did not introduce any other evidence to support this testimony, and the Court was not required to accept self-serving testimony as true. The Court concluded that the taxpayer did not meet its burden in proving that, at the time it entered into the Petromaxx SPA, it reasonably believed that the contract would be completed within two years from its commencement date. Accordingly, Basic Engineering was not eligible to report income from the Petromaxx SPA using the completed contract accounting method.

Although the taxpayer's expert had over 30 years of experience in working with oil refineries and refinery equipment, including international dealings, he did not provide a single concrete example of a project similar to the Petromaxx SPA where the parties conducted operations using a parallel processing system and which was complete within two years from its commencement date.

The Court determined that for purposes of §460, the contract commencement date of the Petromaxx SPA was March 22, 2006, the first date on which the taxpayer incurred costs allocable to the contract when it purchased the Cenco refinery for use in the Petromaxx SPA. Even if the Court concluded that April 30, 2007 (the best efforts date)-and not September 12, 2007 (the default date)-was the relevant delivery date, despite the Petromaxx SPA's not calling for penalties if the taxpayer did not deliver the units by then, the Petromaxx project still could not have been completed within two years from March 22, 2006 (the contract commencement date).

The Court reasoned that the time between the contract commencement date and the best efforts date was 13 months; once the units were delivered, it would take six months to ship them from Texas to Bulgaria. Upon receipt of all of the units, it would take Petromaxx 12 months to assemble the refinery; and once the refinery was assembled, it would take approximately 2½ months to commission and conduct performance tests. In total, a project similar to the Petromaxx refinery project would take over 33 months to complete using traditional industry practices.

The Petromaxx SPA indicated that the taxpayer and Petromaxx anticipated the final payment becoming due on the earlier of: (1) 10 months after the final delivery date (which the Petromaxx SPA defined as September 12, 2007), or (2) the final acceptance date (which was defined as the date on which the qualified engineer issued a completion certificate). Assuming traditional industry practices, this provision put the completion date more than two years after the contract commencement date. The Petromaxx SPA did not require the qualified engineer to issue a completion certificate by a certain date, and 10 months after the September 12, 2007 final delivery date was July 12, 2008-more than two years after the March 22, 2006, contract commencement date.

As with the Petromaxx refinery project, the Court found that Basic Engineering failed to meet its burden to prove that IRS's determination was arbitrary. The terms of the Amber SPA supported IRS's position that the taxpayer did not reasonably estimate that the Amber refinery project could be completed within two years. On its face, the Amber SPA called for a delivery date more than two years after the Amber SPA commencement date. Even if the Court considered the self-serving testimony of taxpayer's expert, Basic Engineering did not provide any evidence to support this testimony. The Court concluded that Basic Engineering did not meet its burden of proving that, at the time it entered into the Amber SPA, it reasonably expected the contract to be complete within two years from its commencement date. Accordingly, Basic Engineering was not eligible to report income from the Amber project using the completed contract accounting method.

Basic Engineering relied only on the unsupported testimony of its expert to refute the testimony of IRS's expert that 4½ years was an optimistic estimate of the time required to complete a project similar to the Amber refinery project. While Basic Engineering noted that IRS's estimate was based on traditional methods and argued that its 3-D laser scanning and parallel processing system allowed it to reasonably estimate that the Amber SPA would be completed within two years, Basic Engineering did not produce any other witnesses, provide the Court or IRS with documentary evidence that would reflect the parties' intent to use a parallel processing system, produce any evidence to show that the parties' conduct reflected an intent to conduct operations using a parallel processing system, or even explain exactly how much time parallel processing would save. Even if the Court assumed that the parties would be completing their tasks simultaneously, the taxpayer did not prove that parallel processing would allow the parties to complete the contract within two years.

The expert testimony was similarly unconvincing with respect to the Amber refinery project. Although the taxpayer's expert had over 30 years of experience in working with oil refineries and refinery equipment, including international dealings, he did not provide a single concrete example of a project similar to the Amber refinery project where the parties conducted operations using a parallel processing system and completed it within two years from its commencement date. And there was no indication that the expert witness's projections took into account any unanticipated delays. The Court concluded that the taxpayer simply had not introduced sufficient evidence to show that its expectations with respect to the Amber refinery project's time frame differed from those objectively manifested in the Amber SPA.

The Court determined that, for purposes of §460, the contract commencement date of the Amber SPA was July 24, 2008 when the taxpayer purchased the Atlas refinery for use in the Amber SPA. The only term in the Amber SPA that referenced a specific date was with respect to the taxpayer's delivery obligations; the Amber SPA clearly stated that the taxpayer was required to deliver the last unit to a specified site by November 15, 2010, approximately 28 months after the July 24, 2008, contract commencement date. If the taxpayer failed to deliver by November 15, 2010, it was subject to penalties; if the taxpayer delivered the last unit before November 15, 2010, it was entitled to bonus payments

Taken together, the delivery date and the potential penalties and bonus payments indicated that the parties intended November 15, 2010, to be the approximate date by which the taxpayer would deliver the last unit. This delivery date occurred more than two years after the contract commencement date (July 24, 2008), and Amber still had to transport the refurbished parts from that site in Turkey to Pakistan, construct the refinery, and commission and performance test the newly assembled refinery before the taxpayer would have satisfied its contractual obligations.

Big River Development LP, TC Memo 2017-166

The Tax Court has once again concluded that a deed of easement executed contemporaneously with the gift of a conservation easement satisfied the §170(f)(8)(B) charitable contribution deduction requirement that there be a "contemporaneous written acknowledgment" by the donee which includes a good faith estimate of the value of any goods or services that the donee provided. And, the Court said that a clause in the deed that stated that the donee would monitor the donor's compliance with the easement did not affect the validity of that acknowledgment.

Under §170, a taxpayer is allowed a charitable contribution deduction for a properly substantiated contribution or gift to or for the use of an organization organized and operated exclusively for charitable or educational purposes. §170(f)(3) generally bars a charitable contribution deduction for a contribution of an interest in property that is less than the taxpayer's entire interest in the property, but an exception is made for a qualified conservation contribution, i.e., the contribution of a qualified real property interest exclusively for "conservation purposes." (§170(h), Regulation §1.170A-14(b)(2)).

Under §170(f)(8)(A), no charitable contribution deduction for any contribution of $250 or more is allowed unless the taxpayer substantiates the contribution with a contemporaneous written acknowledgment of the contribution by the donee organization that meets certain specified requirements. Although the acknowledgment is not required to take any particular form, the donee organization must state in the acknowledgment whether it provided any goods or services in consideration, in whole or part, for the contributed property or cash. (§170(f)(8)(B)(ii)) If so, the acknowledgment generally must include a description and good faith estimate of the value of any goods or services provided.

The Tax Court has held in several cases that certain conservation easement deeds can satisfy §170(f)(8) 's substantiation requirements. In RP Golf, LLC, TC Memo 2012-282, the Tax Court determined that the deed underlying a donor's conservation easement contribution met §170(f)(8) 's substantiation requirements where it sufficiently established that the donee organization did not provide any goods or services in exchange for the easement. The taxpayer executed an agreement granting a conservation easement to a not-for-profit corporation, which, although it referenced consideration, actually recited no amount. The agreement also contained an "entire agreement" clause. Accordingly, the Tax Court found that the agreement, taken as a whole, adequately stated that no goods or services were received in exchange for the contribution.

And, in a case decided just weeks before the current case, *310 Retail, LLC,* TC Memo 2017-164, the Tax Court reasoned that a deed of easement was similar in all material respects to the deed in RP Golf, and the Court reached the same conclusion as there. The deed of easement was properly executed by the donee's president and recorded by the local Recorder of Deeds on the date it was executed.

On January 12, 2005, the taxpayer, Big River Development LP (LP), executed a deed of easement granting the Pittsburgh History and Landmarks Foundation (PHLF) an easement over the facade of a building. PHLF is a qualified charitable organization. PHLF caused the deed to be recorded in the Allegheny County Department of Real Estate in January 2005.

The granting provision of the deed of easement stated as follows: "NOW THEREFORE, in consideration of Ten Dollars ($10.00), the mutual promises hereinafter set forth, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged...[LP] hereby grants and donates to [PHLF], pursuant to Section 170(h) of the Code...the Easement." The deed of easement recited that "the obligations imposed by this Deed shall be effective in perpetuity and shall be deemed to run as a binding servitude with the Property" and "any prior or simultaneous correspondence, understandings, agreements, and representations are null and void upon execution hereof, unless set out in this instrument."

The deed also stated that PHLF would monitor LP's compliance with the easement restrictions and authorized PHLF to inspect the premises to ensure compliance. In order to help defray the costs that PHLF expected to incur in performing such monitoring, the deed provided as follows: "In further consideration for the benefits to be received by...[LP] as a result of the granting of the Easement and the entering into of this Deed... [LP] covenants and agrees to pay [PHLF] a one-time donation fee of $93,500, which will be used to endow periodic easement monitoring and related costs." In the event PHLF's periodic monitoring should disclose a violation of the easement restrictions, the deed of easement entitled PHLF "to enjoin any violation."

LP secured an appraisal that determined a value of $7.14 million for the facade easement, and LP claimed a $7.14 million charitable contribution deduction. LP attached to its return Form 8283, Noncash Charitable Contributions, executed by the appraiser and by PHLF's president. This document contained no statement as to whether PHLF had provided any goods or services to LP in exchange for its gift.

IRS disallowed the charitable deduction.

The Court said that, except with respect to the monitoring provision in the current deed, the deed of easement involved here resembled in material respects the deeds of easement involved in 310 Retail, LLC, and RP Golf, LLC. The deed of easement in this case was properly executed by PHLF's president and recorded in the Allegheny County Department of Real Estate in January 2005. It thus constituted a "contemporaneous" acknowledgment.

The acknowledgment included an affirmative indication that PHLF supplied no goods or services to LP in exchange for its gift. The deed explicitly stated that it reflected the entire agreement between LP and PHLF and that "any prior or simultaneous correspondence, understandings, agreements, and representations are null and void upon execution hereof, unless set out in this instrument." The deed of easement thus negated the provision or receipt of any consideration not stated therein.
Apart from the charitable conveyance and the covenants attending the easement, the deed of easement contains only two references to "consideration." The first is the granting provision's reference to consideration of Ten Dollars ($10.00).and other good and valuable consideration. Neither party contended that PHLF actually furnished LP with any valuable goods or services in exchange for its gift. Evaluating this clause in the context of the deed overall, the Court concluded that this clause constituted boilerplate language and had no legal effect for purposes of §170(f)(8).

The other reference to "consideration" in the deed of easement was the provision that required LP to pay PHLF $93,500 to endow PHLF's periodic easement monitoring and related costs. The Court said that it was unclear whether PHLF's monitoring activity should be regarded as constituting, within the meaning of §170(f)(8)(B)(ii), the provision of a "service" in exchange for LP's gift. By inspecting the building to ensure compliance with the easement restrictions, PHLF would be discharging its own enforcement responsibilities as a charitable organization holding conservation easements. Its monitoring would be an odd form of "service" because it could generate no upside for LP but only downside. If the monitoring disclosed a violation, the deed authorized PHLF to seek an injunction requiring LP to restore the property to the status quo ante and to demand reimbursement for any costs thus incurred.

In any event, the Court said, §170(f)(8) does not prohibit a charity from providing services to a donor. Rather, it requires the charity to provide the donor with a "description and good faith estimate of the value" of any services supplied in exchange for the gift. In the deed of easement, PHLF charged LP a fee of $93,500 and adequately described the "services" for which this fee was being paid.
The Court concluded that PHLF thereby supplied LP with a "description and good faith estimate" of the value of its monitoring activities.

15 West 17th Street LLC, (12/22/2016) 147 TC No. 19.

The rule of §170(f)(8)(D), which provides a waiver of the requirement that a charitable donor secure and maintain a contemporaneous written acknowledgment (CWA) from the donee with respect to certain information if the donee files a return with that information "on such form and in accordance with such regulations as the Secretary may prescribe," does not apply currently because IRS has not yet issued such regulations.

Charitable contribution deductions are allowable only if the taxpayer satisfies substantiation requirements. (§170(a)(1)) The nature of the required substantiation depends on the size of the contribution and on whether it is a gift of cash or property.

For contributions of $250 or more, a taxpayer generally must obtain a contemporaneous written acknowledgment from the donee. (§170(f)(8)(A)) This acknowledgment must: (1) include a description (but not value) of any property other than cash contributed; (2) state whether the donee provided any goods or services in exchange for the gift; and (3) if the donee did provide goods or services, include a description and good-faith estimate of their value. The acknowledgment is contemporaneous if the taxpayer obtains it from the donee on or before the earlier of: (a) the date the taxpayer files a return for the year of contribution; or (b) the due date, including extensions, for filing that return. (§170(f)(8)(B), Regulation §1.170A-13(f))

The substantiation requirements of §170(f)(8)(A) do not apply to a contribution "if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe," that includes the information specified in §170(f)(8)(B). (§170(f)(8)(D)) To date, IRS has not issued regulations to implement the donee-reporting regime referred to in §170(f)(8)(D).

In 2007, 15 West 17th Street LLC (LLC) contributed an easement to a charitable organization (Trust). On May 14, 2008, the Trust sent the LLC a letter acknowledging receipt of the easement. This letter did not state whether the Trust had provided any goods or services to the LLC, or whether the Trust had otherwise given the LLC anything of value, in exchange for the easement.

The LLC took a deduction for the contribution on its 2007 return. It included with that return a copy of an appraisal report, a copy of the Trust's May 14, 2008, letter, and Form 8283, Noncash Charitable Contributions, executed by the appraiser and by a representative of the Trust.

After the case was docketed in the Tax Court, the donee organization submitted an amended Form 990, Return of Organization Exempt from Income Tax, that included the information specified in §170(f)(8)(B). LLC filed a motion for partial summary judgment, contending that this action by the donee eliminated the need for a CWA to substantiate LLC's gift.

The majority Tax Court opinion held that: a) §170(f)(8)(D) sets forth a discretionary delegation of rulemaking authority, and it is not self-executing in the absence of the regulations to which the statute refers; b) the general rule set forth in §170(f)(8)(A), requiring a CWA meeting the requirements of §170(f)(8)(B), was fully applicable to the gift at issue.

By its terms, the delegated rulemaking authority is permissive: It grants IRS discretion to prescribe regulations governing this matter, but it does not mandate that it do so.

The discretionary nature of this delegated authority is underscored by comparing the text of §170(f)(8)(D) with the text of §170(f)(8)(E). The latter provides that "the Secretary shall prescribe regulations" specifying that "some or all of the requirements of this paragraph do not apply in appropriate cases." The delegation of rulemaking authority in §170(f)(8)(E), including the words "shall prescribe," is phrased in mandatory terms. The Court said that it necessarily presumed that Congress intended a different meaning in §170(f)(8)(D) when it used the word "may" rather than "shall.

When §170(f)(8) was passed into law, Congress "plainly understood that donee reporting raised serious policy questions... regarding donor privacy and the security of taxpayer information... which the Secretary would need to address before any such alternative could be implemented. This is a classic example of a situation in which Congress has delegated discretionary, policy-making authority to the Secretary."

A dissenting judge noted that §170(f)(8)(D) provides that "subparagraph (A) shall not apply to a contribution if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe, which includes the information described in subparagraph (B) with respect to the contribution." He said that the first clause establishes whether §170(f)(8)(A) applies when the donee organization files a return, and the second clause merely establishes that IRS may provide alternative rules detailing how a donee organization may file such a return.

He concluded that IRS's failure to create such rules and issue new forms does not render §170(f)(8)(D) inoperative. "We have frequently held that the Secretary may not prevent implementation of a tax benefit provision simply by failing to issue regulations."

Gardner, TC Memo 2017-165

Taxpayer's charitable contribution of hunting specimens (animal hides and skulls) should be valued using the comparable sales method and not the replacement cost method as was argued by the taxpayer.

If a taxpayer makes a charitable contribution of property other than money, the amount of the contribution is generally equal to the fair market value (FMV) of the property at the time the gift is made. (Regulation §1.170A-1(c)(1)) FMV is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." (Regulation §1.170A-1(c)(2))

The taxpayer, Mr. Gardner, was an avid big-game hunter. He opted to downsize his trophy collection by donating to an ecological foundation many of his less desirable hunting specimens. Relying on an appraisal, he claimed a charitable contribution deduction of $1,425,900. IRS valued the donation at $163,000.

The donation consisted of 177 specimens, none of which were of "record book" quality. Certain hunting organizations maintain record books of big-game kills using proprietary scoring systems. A specimen may qualify for listing in record books on the basis of the animal's size, other physical features, or unusual provenance (i.e., aspects of the hunt or of the animal's history). One such record book was compiled by the Safari Club International (SCI). At the time Gardner selected the 177 specimens for donation to DEF, he had three kills ranked in the SCI record book. But he did not select any specimen from those kills for contribution to the charity.

Gardner hired Mr. Fullington, an appraiser, to appraise the 177 specimens. Fullington used a replacement cost method. He estimated what it would cost to replace each item with a specimen of like quality by tallying up the expected out-of-pocket expenses for traveling to the hunting site, being on safari for the requisite number of days, killing the animal, removing and preserving the given body part, shipping it back to the U.S., and defraying the taxidermy costs of stuffing, mounting, or otherwise preparing the item for display.

Fullington issued a report supporting his calculations. Although Fullington gave every single item a rating of "excellent" with respect to "specimen quality" and "taxidermy quality, " the Court said that his photographs often suggested that a lower rating would have been appropriate. His entries under the "provenance" category were meager, "suggesting that Fullington may have lacked confidence in the specimen's actual provenance." Fullington supplied no evidence to support the premise for his adoption of a replacement cost approach.

Because the donated specimens had been dispersed to unknown locations and were no longer accessible, none of the experts who testified at trial was able to conduct a physical inspection to assess the specimens' quality. The experts' quality assessments thus had to be based on Fullington's photographs.

IRS's expert was Mr. Ketner, a licensed taxidermist for more than 30 years and a certified appraiser specializing in taxidermy items. Ketner's testimony characterized the donated specimens as consisting mostly of "remnants and scraps" of a trophy collection. "It's what's left over when you're done mounting an animal," or what is "not needed for what's hanging on the wall." He opined that there "has always been a market" for such items. Historically, "taxidermists would buy, sell, swap, or trade these items as they were needed...to complete projects, or to mount for their own collections."

Gardner had two experts, neither of whom assigned a value to the specimens; rather, each sought only to defend replacement cost as the proper valuation methodology. Both experts made a point of emphasizing the excellent quality of, and the provenance information about, the specimens. However, they cited only the Fullington report as support for those conclusions.
The Court agreed with IRS that the comparable sales method applied.

The Court began by noting that it had decided previous cases involving charitable contribution of hunting specimens. It concluded from those cases that, if an active market exists, courts generally rely on comparable sales. In *Epping,* TC Memo 1992-279, which involved "an assortment of animal mounts, horns, rugs, and antlers," the Court found that "an active market exists with substantial comparable sale items."

The Court also noted that replacement cost may be a relevant measure of value where the property is unique, the market is limited, and there is no evidence of comparable sales. For a court to eschew comparable sales in favor of replacement cost, the taxpayer must establish not only the absence of an active market for comparable items, but also a probative correlation between replacement cost and FMV.

The Court said that Ketner's written and oral testimony persuaded it that the 177 donated items were neither world-class trophies nor museum-quality research specimens. Gardner's own testimony indicated that he wished to "downsize" his collection by ridding himself of unwanted items. Although his experts asserted that all specimens were of "excellent" quality, they offered no factual backing for that assertion and admitted that Fullington's photographs often indicated the opposite. And although Gardner had participated in several record hunts, not a single specimen that he selected for donation to the charity was of record-book quality.

In short, the 177 specimens were clearly commodities, not collectibles. For commodities such as these, the determination of FMV will generally be based on market prices for similar items. Ketner credibly testified that an active market existed in which taxidermied products like Gardner's have long traded and that the internet has vastly expanded that marketplace. Indeed, he found 504 comparable sales transactions on traditional and internet auction sites. Gardner offered no evidence or expert testimony to contradict Ketner's testimony that an active market for such items existed at the time of the gift.

Gardner did not seriously challenge Ketner's data and introduced no evidence of market prices for comparable items. Gardner thus failed to carry his burden of proving that the FMV of the 177 specimens exceeded the $163,045 value that IRS allowed in the notice of deficiency.

The Court also noted the very limited use of replacement cost in hunting specimen valuation cases. It said that replacement cost had historically only been used where the specimens were "world-class trophy mounts" and where the market was "rather thin and not established." And, even then, replacement cost was only used as part of a formula to increase the amount shown by the comparable sales method when the court found that the comparable sales presented to it resulted in a too low valuation. None of those factors applied here.

Gregory (2017) 149 TC No. 2.

The term "taxpayer" in §468 includes cash method taxpayers and does not apply only to accrual method taxpayers. Accordingly, the cash method taxpayer that operated a landfill business was allowed to currently deduct its estimated clean-up costs.

Under §468, mine and waste disposal site closing and reclamation expenses are not deductible until, and only to the extent that, these activities are actually performed, unless a special election is made to deduct additions to a reserve for future closing and reclamation costs.

§468(a)(1) provides that if a taxpayer elects the application of this section with respect to any mining or solid waste disposal property, the amount of any deduction for qualified reclamation or closing costs for any taxable year to which such election applies shall be equal to the current reclamation or closing costs allocable to

1. In the case of qualified reclamation costs, the portion of the reserve property which was disturbed during such taxable year, and

2. In the case of qualified closing costs, the production from the reserve property during such taxable year.

§468(a)(1) lets taxpayers who own landfills deduct now a portion of what it will cost to clean them up in the future-even if that future is many years away.

In 1988, Bob and Kay Gregory incorporated their landfill business, Texas Disposal Systems Landfill, Inc. (TDSL). The Gregorys chose to make TDSL a cash method taxpayer when they incorporated it. TDSL elected to be taxed as an S corporation.

TDSL is legally required to pay reclamation and closing costs if and when it closes the landfill.

TDSL did not at first claim any deductions for its estimated clean-up costs. But in 1996, TDSL discovered it was eligible to currently deduct these costs under §468. TDSL made the election and claimed the §468 deduction for the first time on its 1996 tax return.

On its 2008 return, TDSL took a slightly more than $100,000 deduction for estimated clean-up costs. On its 2009 return, it took a slightly smaller deduction. TDSL had not actually paid those clean-up costs, it simply estimated the costs.

In April of 2013, IRS sent the Gregorys notices of deficiency for their 2008 and 2009 tax years that disallowed these deductions because TDSL was a cash method taxpayer.

The Gregorys contended that "taxpayer" in §468 refers to any taxpayer, including cash method taxpayers like TDSL. On the other hand, IRS contended that §468 applies only to accrual method taxpayers.

The Tax Court held that the term "taxpayer" in §468 includes cash method taxpayers and is not limited to accrual method taxpayers.

The Court reasoned that the language of §468 does not limit the election to accrual method taxpayers. IRS acknowledged this. §468(a)(1) just tells a "taxpayer" who makes a §468 election how to calculate the deduction. Where not otherwise distinctly expressed or manifestly incompatible with the intent of the provision, §7701(a)(14) defined the term "taxpayer" as "any person subject to any internal revenue tax" (the default definition). The definition of taxpayer is simple, broad, and does not distinguish entities that use the accrual method from those that use the cash method.

The question, the Court concluded, was whether in §7701(a)(14), the person-which included corporations like TDSL-was "subject to any internal revenue tax." TDSL was a corporation and like other S corporations it was required to pay Social Security and unemployment (albeit not income) taxes. So, the Court concluded, TDSL was a "taxpayer."

The Court also found that there was nothing in the default definition in §7701(a)(14) "manifestly incompatible" with §468. A taxpayer currently deducting clean-up costs is what §468 is all about.

The Court noted that "taxpayer" is one of the most basic terms in the Code. It is also one that Congress itself knows how to modify as context requires. The Court reasoned that Congress could have, as it has on numerous occasions, said "accrual method taxpayer," but it chose not to do so.

The Tax Court further concluded that a cash method taxpayer must make a §468 election to currently deduct estimated reclamation, closure, and post-closure costs before the costs are paid. TDSL did make such an election. Accordingly, it could currently deduct its estimated reclamation and closing costs.

A concurring opinion agreed with the result of the majority decision, but with some reluctance. The concurrence reasoned that the legislative history indicated that Congress likely intended that the election to set up reserves for mining and waste site reclamation costs would be available only to accrual basis taxpayers. However, quite possibly because of a last-minute drafting glitch, Congress did not reflect this intent in the text of §468 as it was actually enacted.

The concurrence opined that if IRS, in reliance on the legislative history, had issued regulations that defined "taxpayer" for purposes of §468 to mean "accrual basis taxpayer," the outcome of this case might have been different.

Hann, (Ct Fed Cl 8/16/2017) 119 AFTR 2d ¶ 2017-5156.

The Court of Federal Claims has held that, where an employee exercised nonqualified stock options and then immediately sold the stock as part of the employer's initial public offering (IPO), the amount that the IPO underwriters charged when they sold the shares to the public reduced the taxpayer's sale proceeds and was not deductible from ordinary income.

An employee who receives nonqualified stock options as compensation for services performed realizes ordinary income. (§83(a)) However, if the options lack a readily ascertainable fair market value at grant, the employee does not immediately recognize income. (§83(e)(3)) Instead, the employee recognizes income upon exercising the option. (Regulation §1.83-7(a)) When an employee exercises nonqualified stock options, the employee must include in his gross income the difference between the option stock's fair market value at exercise and the amount paid to acquire the option stock. (§83(a)(1))

The taxpayers were Mr. and Mrs. Hann. Mr. Hann was the Chief Financial Officer of Wesco Aircraft ("Wesco"). In 2009, while still a privately held company whose shares were not sold on an established securities market, Wesco granted Hann nonqualified stock options as compensation.

In 2011, Wesco issued a memorandum to its employees regarding the proposed IPO Wesco was arranging on behalf of its primary shareholders. The memorandum informed employee equity holders, including Hann, that Wesco would provide them "an opportunity to sell a portion of their eligible shares in the proposed offering alongside" the primary shareholders. However, participating employee equity holders were required to sell the same proportion of their shares as the primary shareholders. Therefore, participation required option holders to authorize the sale of their eligible shares and the automatic exercise of their stock options to comply with the proportionality requirement.

There also existed a "lock-up agreement" under which no Wesco shareholders could sell any of their shares other than as part of the IPO for a period of 180 days after the IPO.

The prospectus for the IPO contained the following: the public offering price of the stock would be $15 per share; the underwriting commissions would be $0.8625 per share; and the proceeds to the selling shareholders would be $14.1375 per share.

Wesco agreed to pay expenses incurred by the selling stockholders in connection with the offering, other than the underwriting commission.

Hann elected to participate in the IPO. Wesco arranged for a "cashless exercise," whereby participating option holders did not pay the exercise price out of pocket. Rather, the exercise price was deducted from the compensation the participant received from the underwriters. As a result, Hann exercised 89,139 options and immediately sold these 89,139 shares to the underwriters, who paid Hann $14.1375 per share. The underwriters then sold these shares to the public at $15 per share, taking a "commission" of $0.8625 per share. Hann did not take physical custody of any shares pursuant to his participation in the IPO. However, as Wesco's Chief Legal Officer acknowledged, to participate in the IPO, Hann needed to exercise his options and own shares.

Hann's Form W-2 from Wesco showed compensation income based on the number of shares exercised multiplied by $15 per share less the option exercise price. Hann reported that income but also reported a $76,000 deduction from ordinary income for the amount of the underwriters' commission.

Hann made the following four arguments that the underwriters' commission resulted in a deduction from ordinary income, and the court rejected all of those arguments, finding instead that the commission reduced his proceeds from the sale of the stock.

Everything that took place was, in effect, a single transaction. Hann argued that he engaged in a single-step transaction whereby he exercised his options and received cash proceeds. He argued that he never took possession of any stock and that Wesco's requirements with respect to the IPO did not allow him to receive common stock upon exercise of the options. Therefore, in the Hanns' view, the underwriters' commission should offset the Hanns' ordinary income.

The court said that, while Hann's participation in the IPO did not entitle him to retain common stock upon exercising his options, in order to participate in the IPO, Hann needed to acquire Wesco shares via his options and then immediately resell the shares to the underwriters. Hann held legal - if not physical - ownership of the shares when he exercised the options. Only after Hann gained legal ownership of the shares could he sell those shares to the IPO underwriters. The short duration of Hann's legal ownership of the Wesco shares did not alter the tax consequences of his ownership and sale of the stock. The acquisition of Wesco stock pursuant to his stock options followed by the immediate resale of the Wesco stock to the underwriters was necessarily a two-step transaction. That Wesco agreed to accept payment of the exercise price directly from the underwriters did not change the taxable steps taken by Hann.

At the time of exercise, the Hanns were required to recognize as ordinary income the difference between the option stock's fair market value at exercise ($15 per share) and the amount paid to acquire the option stock. On the sale, the Hanns realized $15 per share in the fair market value of the option stock paid by the underwriters. However, because Hann paid the underwriters' commission as a cost of participating in the IPO and selling his Wesco shares, the Hanns had to reduce the amount realized by the $0.8625 per share for the underwriters' commission, to a net amount realized of $14.1375 per share. The underwriters' commission was incurred by all IPO participants to sell the Wesco stock to the underwriters and was a capital expense.

Taxpayer could not have exercised the options without paying the underwriters' commission. The Hanns argued that because Hann could not have exercised the options without paying the underwriters' commission, the commission was an "amount paid" to exercise the options under §83.

The court said that the Hanns' theory failed because payment of the underwriters' commission was not required for Hann to exercise his options, but was compensation to the underwriters for valuing and establishing a public market for Wesco stock for the IPO. Contrary to the Hanns' assertions, Hann could have exercised the options without paying the underwriters' commission. Rather than effect a cashless exercise, Hann was entitled to exercise the options, pay the exercise price, and retain ownership of the shares that he purchased.

The Hanns next argued the underwriters' commission was an ordinary and necessary expenditure incurred in a trade or business. The Hanns claimed Hann's trade or business was being "an executive of Wesco Aircraft" and that the underwriters' commission was "an ordinary and necessary business expense directly connected with the exercise of the option and the related generation of ordinary income."

But the court said that exercising his options made Hann a shareholder in Wesco - separate from his status as an employee. An individual who is both an employee and shareholder must acknowledge that dual status and separately determine the tax consequences of each activity.

The Hanns argued that "the income generated to the Hanns is ordinary income, and there is no situation in which the exercise of these options could be treated as a capital gain; therefore the expenses required to generate this ordinary income should be ordinary in nature as well."
The court said that the Hanns' focus on the ordinary income generated by the option exercises ignored the economic reality that Hann sold his Wesco shares and opted to participate in the IPO. The IPO participants, including Hann, paid the underwriters' commission in order to sell their shares to the underwriters, not in order to exercise their options.

Jacobs, (2017) 148 TC No. 24.

The Boston Bruins hockey team's provision of pregame meals to Bruins' players and personnel at away city hotels qualifies as a de minimis fringe under §274(n)(2)(B) and that therefore the cost of such meals is not subject to the 50% limitation of §274(n)(1).

§274(n) imposes a 50% limitation on the deduction for meal expenses unless an exception applies. §274(n)(2)(B) provides such an exception, if the expense for food or beverages is excludable from the gross income of the recipient under §132(e) (relating to de minimis fringes).

One of the de minimis fringe rules, §132(e)(2), requires that "access to the [eating] facility is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of highly compensated employees."

Employee meals provided in a nondiscriminatory manner constitute a de minimis fringe under §132(e) if: (1) the eating facility is owned or leased by the employer; (2) the facility is operated by the employer; (3) the facility is located on or near the business premises of the employer; (4) the meals furnished at the facility are provided during, or immediately before or after, the employee's workday; and (5) the annual revenue derived from the facility normally equals or exceeds the direct operating costs of the facility (the revenue/operating cost test). (§132(e)(2); *Boyd Gaming Corporation ,* (1996) 106 TC 343; Regulation §1.132-7(a))

The taxpayer was the owner of the Boston Bruins. The Bruins are a National Hockey League (NHL) professional hockey team.

Half of the team's games are played away from Boston, in "away cities." The NHL requires teams to arrive in the away city at least six hours before the start of an away game. The collective bargaining agreement--which binds the NHL, member teams, and players of member teams--requires that an NHL team travel to an away city the day before game day if the flight to the away city is greater than 150 minutes.

The Bruins traveled to every away game with the following personnel: between 20 and 24 players, the head coach, assistant coaches, medical personnel, athletic trainers, equipment managers, communications personnel, travel logistics managers, public relations/media personnel, and other employees (traveling hockey employees).

The Bruins contract with away city hotels provide for sleeping accommodations and banquet or conference rooms (meal rooms) where pregame meals and snacks are served. Each away city hotel prepares pregame meals (i.e., breakfast, lunch, or brunch) and snacks that meet the players' specific nutritional guidelines to ensure optimal performance for the upcoming game and throughout the remainder of the season. The food is made available to all traveling hockey employees. The Bruins initiate the meal contracting process by providing a custom meal menu to the prospective away city hotel requesting specific types and quantities of food. Using this custom meal menu the hotel prepares and sends to the Bruins a banquet event order (BEO). The meal room itself is provided to the Bruins at no extra cost.

For every breakfast and lunch, traveling hockey employees must be present in the meal room. Aside from nutrition, those meals also provides the Bruins with a chance to conduct team business. Bruins players will meet with coaches-- either one-on-one or in small groups--to discuss strategy and review game film. The public relations staff also attends breakfast, where they meet with players concerning anticipated media inquiries, interviews, or other public-facing issues.

The Bruins met the de minimis fringe requirements. The Court determined that the Bruins met all of the above-described de minimis tests and thus were not subject to the 50% limitation on the deduction for their away game team meals.

1. **The nondiscrimination test.** The Bruins provided pregame meals to all traveling hockey employees, and the Court found this classification (i.e., Bruins employees traveling to away cities to perform business duties) to be a reasonable classification given the nature of the team's business. The Bruins provided credible testimony that the pregame meals were made available to all Bruins' traveling hockey employees--highly compensated, nonhighly compensated, players, and nonplayers--on substantially the same terms. The Bruins also provided testimony, which the Court found credible, that any discrepancy between anticipated and actual meal attendees was a function of cost reduction concerns and not discrimination.

   The Court therefore held that the Bruins' provision of pregame meals to traveling hockey employees satisfied the nondiscriminatory manner requirement of §132(e)(2).

2. **Eating facility is owned or leased by employer**. Regulation §1.132-7(a)(2)(i) does not define the word "lease." Black's Law Dictionary provides that a lease is a contract by which a rightful possessor of real property conveys the right to use and occupy the property in exchange for consideration.

   Although the BEOs and hotel contracts entered into between the Bruins and the away city hotels are not specifically identified as "leases," the substance of these contracts indicates that the Bruins are paying consideration in exchange for "the right to use and occupy" the hotel meal rooms. The Bruins' execute BEOs and hotel contracts with each away city hotel to occupy meal rooms and determine what types of food are served, and the BEOs specify the dates and times of the meals and the anticipated number of attendees. The Bruins do not provide separate consideration for the rental of the meal rooms; however, the meal rooms are essential to the Bruins' away city business operations, and the hotels agree to provide the meal rooms free of charge because the Bruins spend money for lodging and food. The Bruins dictate several aspects regarding the setup of the meal rooms.

   The Court concluded that the Bruins contracted with away city hotels for the right to "use and occupy" meal rooms to conduct team business, and therefore those agreements were substantively leases.

3. **Operated by the employer.** The eating facility must be operated by the employer. (Regulation §1.132-7(a)(2)(ii)) Regulation §1.132-7(a)(3) provides, "If an employer contracts with another to operate an eating facility for its employees, the facility is considered to be operated by the employer for purposes of this section."

   The Bruins contract with each away city hotel regarding the operation of the meal rooms as well as food preparation and service. Several weeks before the Bruins travel to the away city hotel, they provide meal requirements to the hotel. The BEOs also typically provide for the furnishings and setup of the meal room and the hotel staff that will assist in preparing and serving the food.

   IRS argued: "the Bruins did not note to the Court the repeated instances that the BEOs, as well as the eventual bills, checks, and invoices show sales taxes were imposed on the food charges. Such assessments demonstrate that the BEOs were not contracts for services, but instead, in form and substance, meal purchase orders." IRS concluded that the operation of the away hotel meal rooms did not reflect "the operation of an established and fixed food preparation and/or eating facility...but only the purchase of a few meals on an individual day to be held in a private room." The Court found no merit to this argument.

   The Court found that by engaging in the above-described process with away city hotels, the Bruins were "contract[ing] with another to operate an eating facility for its employees."

4. **Business premises.** For employee meals at an employer-operated eating facility to qualify as a de minimis fringe, §132(e)(2) requires that the eating facility be "located on or near the business premises of the employer."

   The Court said that an employer's business premises is a place where employees perform a significant portion of duties or where the employer conducts a significant portion of business. It is not necessary for an eating facility to be located in an employer's principal structure for it to be considered on the business premises.

   The Court concluded that away city hotels were part of the Bruins' business premises for the years in issue. Staying in away city hotels is indispensable to the Bruins' preparation and is also necessary for maintaining a successful hockey operation and navigating the rigors of an NHL-mandated schedule. The away city hotels provide lodging so Bruins' players can obtain adequate rest, which is essential to professional athletes playing a physical sport with games scheduled in short succession. The Bruins contract with each away city hotel to set up a private meal room and to provide meals/snacks that meet the players' specific nutritional guidelines, which ensures optimal performance for the upcoming game and throughout the remainder of the season. Not only do the pregame meals provide essential nutrition for the players, but they also serve as a forum for the Bruins to maximize preparation time and conduct team business.

The Court rejected IRS's argument that the traveling hockey employees' activities at away city hotels are insignificant because: (1) the activities at away city hotels are qualitatively less important than playing in the actual hockey game and (2) the Bruins spend quantitatively less time at each away city hotel than they do at the team's Boston facilities. The Court noted that IRS did not provide precedent to support either of these arguments

5. **Meals furnished during, before, or after employee's workday**. IRS conceded that this requirement was met.

6. **Revenue/operating cost test.** For employee meals at an employer-operated eating facility to qualify as a de minimis fringe, §132(e)(2)(B) requires that revenue derived from the employer-operated eating facility equal or exceed the direct operating costs of the facility. §132(e) provides that "an employee entitled under §119 to exclude the value of a meal provided at such facility shall be treated as having paid an amount for such meal equal to the direct operating costs of the facility attributable to such meal." Regulations provide that an employer-operated eating facility satisfies the revenue/operating cost test if the employer can reasonably determine that the meals are excludable to the recipient employees under §119. (Regulation §1.132-7(a)(2)) Meals are excludable to recipient employees under §119 if they are (1) furnished for the convenience of the employer and (2) furnished on the business premises of the employer. (§119(a))

The Court looked to its discussion above regarding the business premises requirement. As to the convenience of the employer, the Court noted that providing meals to traveling hockey employees at away city hotels enables the Bruins to effectively manage a hectic schedule by minimizing unproductive time (e.g., finding and obtaining appropriate meals from restaurants in each city) and maximizing time dedicated to activities that help achieve the organization's goal of winning hockey games. The Court said that the Bruins provided credible evidence establishing the business reasons for furnishing pregame meals to traveling hockey employees.

The Malulani Group, Limited and Subsidiary, TC Memo 2016-209.

A like-kind exchange series of transactions, that involved a qualified intermediary and the acquired property being acquired from a related party, violated the §1031 related party rules despite the fact that, when the transactions were planned, the taxpayer had no intention of involving the related party.

Taxpayers can defer recognizing gain or loss on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for like-kind property that will be held for productive use in a trade or business or for investment. (§1031(a))

A nonsimultaneous exchange, where the relinquished property is transferred before the replacement property is acquired, generally may qualify for nonrecognition of gain if the taxpayer identifies the replacement property, and then receives it, within 45 days and 180 days, respectively, of the transfer of the relinquished property. (§1031(a)(3)) A taxpayer may use a qualified intermediary to facilitate such a deferred exchange-in that case, the intermediary acquires the relinquished property from the taxpayer, sells it, and uses the proceeds to acquire replacement property that it transfers to the taxpayer in exchange for the relinquished property. The taxpayer's transfer of relinquished property to a qualified intermediary and subsequent receipt of like-kind replacement property from the qualified intermediary is treated as an exchange with the qualified intermediary. (Regulation §1.1031(k)-1(g)(4)(i))

§1031(f) limits nonrecognition treatment under §1031(a) in the case of like-kind exchanges between related persons. The House Report for the legislation that enacted §1031(f) provided: "Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale...The committee believes that if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, 'cashed out' of the investment, and the original exchange should not be accorded nonrecognition treatment." (H.R. Rept. No. 101-247 (1989)) §1031(f)(1) generally provides that if a taxpayer and a related person exchange like-kind property and within two years either one disposes of the property received in the exchange, the nonrecognition provisions of §1031(a) do not apply, and gain or loss must be recognized as of the date of the disposition.

Although §1031(f)(1) disallows nonrecognition treatment only for direct exchanges between related persons, §1031(f)(4) provides that nonrecognition treatment does not apply to any exchange which is part of a transaction or series of transactions "structured to avoid the purposes of" §1031(f). Therefore, §1031(f)(4) may disallow nonrecognition treatment of deferred exchanges that only indirectly involve related persons because of the interposition of qualified intermediaries. (*Ocmulgee Fields, Inc.,* (2009) 132 TC 105)

§1031(f)(2)(C) provides that any disposition of the relinquished or replacement property within two years of the exchange is disregarded if the taxpayer establishes to the satisfaction of IRS, with respect to the disposition, "that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax." Any inquiry under §1031(f)(4) as to whether a transaction is structured to avoid the purposes of §1031(f) should also take into consideration the "non-tax-avoidance exception" in §1031(f)(2)(C). (*Teruya Bros.,* (2005) 124 TC 45; Ocmulgee)

The taxpayer, MBL, was the wholly-owned subsidiary of Malulani Group, Limited. MIL was a related corporation.

On October 31, 2006, MBL accepted an offer to sell its Maryland real property. Thereafter, MBL began a search for suitable replacement property with the aid of real estate brokers. On January 4, 2007, MBL engaged FAEC to serve as an intermediary through which the Maryland property could be exchanged.

On January 10, 2007, MBL transferred the Maryland property to FAEC, and FAEC sold the Maryland property to the third party for a price of $4,703,000 with closing costs of $71,725. MBL's basis in the Maryland property was $2,743,235.

In order to meet the requirements of §1031(a)(3), MBL had to identify replacement property on or before February 24, 2007 (i.e., 45 days after the sale of the Maryland property). Between October 31, 2006, and February 23, 2007, brokers presented numerous properties owned by unrelated parties to the MBL as potential replacement properties, and MBL attempted to negotiate the purchase of an office building and an apartment building for that purpose. Until February 23, 2007, did not consider acquiring a replacement property from MIL or any other related party. On that date, MBL first identified three potential replacement properties, all belonging to MIL.

On July 3, 2007, FAEC purchased Hawaii real property owned by MIL (Hawaii property) for $5,520,000 and transferred it to MBL as replacement property for the Maryland property. MIL's basis in the Hawaii property was $2,392,996.

MBL's 2007 return reported a realized gain of $1,888,040 from the sale of the Maryland property but deferred recognition of the gain pursuant to §1031. MBL also reported an unrelated $748,273 net operating loss (NOL), which it carried back to 2005. MIL recognized on its 2007 Form 1120 a $3,127,004 gain from the sale of the Hawaii property, which would have increased its regular income tax liability by $1,094,451. However, MIL had sufficient NOLs to fully offset its regular tax liability relating to the sale. It instead paid $44,774 in alternative minimum tax.

IRS issued MBL a statutory notice of deficiency in which it determined that MBL's $1,888,040 gain realized on the sale of the Maryland property did not qualify for §1031 deferred recognition.

The Court held that MBL violated §1031(f)(4) and thus could not avail itself of §1031(a) 's nonrecognition rule.

The Court said that the transactions at issue were similar to those involved in Ocmulgee and Teruya. In those cases, the taxpayers received replacement property from related persons in deferred exchanges involving qualified intermediaries, followed by the related persons' sales of the relinquished property. The Court in those cases concluded that the transactions were the economic equivalent of direct exchanges of property between the taxpayers and the related persons, followed by the related persons' sales of the relinquished property and retention of the cash proceeds. Thus, the investment in the relinquished property had been cashed out, contrary to the purpose of §1031(f).

The Court here said that transactions at issue were no different: the investment in the Maryland property was cashed out with a related person retaining the cash proceeds.

MBL argued that the exchange of the Maryland and Hawaii properties was not structured to avoid the purposes of §1031(f) because MBL had no "prearranged plan" to conduct a deferred exchange with MIL, citing the following example in the legislative history: "For example, if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under §1031, the related party will not be entitled to nonrecognition treatment under §1031." (H.R. Rept. No. 101-247 (1989))

MBL argued that it had no prearranged plan because it first diligently sought a replacement property held by an unrelated party and only turned to the Hawaii property when the deadline to complete a deferred exchange was imminent. MBL also emphasized that it decided to acquire the replacement property from a related person only after it had already engaged a qualified intermediary, whereas in Ocmulgee and Teruya. The taxpayers had decided to acquire replacement properties from related persons before hiring qualified intermediaries.

But the Court said that it considered and rejected similar arguments in Ocmulgee. The taxpayer in that case had, like MBL, first made attempts to find a suitable replacement property held by an unrelated person before turning to property held by a related person. The Ocmulgee Court concluded, however, that the presence or absence of a prearranged plan to use property from a related person to complete a like-kind exchange is not dispositive of a violation of §1031(f)(4).

Because the absence of a prearranged plan is not dispositive regarding a violation of §1031(f)(4), the Court concluded that it was not material that MBL engaged a qualified intermediary before deciding to acquire replacement property from a related person.

Instead, the inquiry into whether a transaction has been structured to avoid the purposes of §1031(f) has historically focused on the actual tax consequences of the transaction to the taxpayer and the related party, considered in the aggregate, as compared to the hypothetical tax consequences of a direct sale of the relinquished property by the taxpayer. Those actual consequences form the basis for an inference concerning whether the transaction was structured in violation of §1031(f)(4). The Court in both Teruya and Ocmulgee compared the hypothetical tax that would have been paid if the taxpayer had sold the relinquished property directly to a third party with the actual tax paid as a result of the taxpayer's transfer of the relinquished property to the related person in a like-kind exchange followed by the related person's sale of the relinquished property. Where the aggregate tax liability of the taxpayer and the related person arising from their like-kind exchange and sale transaction is significantly less than the hypothetical tax that would have arisen from the taxpayer's direct sale of the relinquished property, the Tax Court, in Ocmulgee and Teruya inferred that the taxpayer had a tax-avoidance purpose.

MBL would have had to recognize a $1,888,040 gain had MBL directly sold the Maryland property to an unrelated third party. Although MBL's NOLs would have offset a portion of this gain, it would have paid an additional $387,494 in tax for 2007 as a result of the direct sale. MBL would have also owed an additional $264,171 of tax for 2005 because of the loss of that NOL carryback. However, because the transaction was structured as a like-kind exchange, only MIL was required to recognize gain-and that $3,127,004 of gain was almost entirely offset by its NOLs.

MBL pointed out the "net economic detriment" MBL and MIL suffered on account of the loss of the NOLs that MIL used to offset the 2007 gain recognized from its disposition of the Hawaii property. However, the Court noted that MBL failed to present any evidence that MIL had taxable income in subsequent years which could have been offset with the NOLs used for 2007 and therefore that MBL and MIL sustained any net economic detriment because of their use for that tax year.

The Court said that the substantial economic benefits to MBL and MIL as a result of structuring the transaction as a deferred exchange were thus clear: MBL was able to cash out of the investment in the Maryland property almost tax free. Thus, the Court inferred that MBL had a tax-avoidance purpose.

MBL argued that the transaction nonetheless lacked a tax-avoidance purpose because it did not involve the exchange of low-basis property for high-basis property. It looked to H.R. Conf. Rept. No. 101-386 (1989), where the Congressional conference committee explained that the non-tax-avoidance exception of §1031(f)(2)(C) generally will apply to transactions that do not involve the shifting of basis between properties.

The Court said that it was true that MIL recognized more gain on the disposition of the Hawaii property than MBL realized on the disposition of the Maryland property. However, MIL was able to offset the gain recognized with NOLs, resulting in net tax savings to MBL and MIL as an economic unit. Citing Teruya, the Court said that net tax savings achieved through use of the related party's NOLs may demonstrate the presence of a tax-avoidance purpose notwithstanding a lack of basis shifting.

In sum, by employing a deferred §1031 exchange transaction to dispose of the Maryland property, MBL and MIL, viewed in the aggregate, in effect, cashed out of the investment-in stark contrast to the substantial tax liability MBL would have incurred as a result of a direct sale. Consequently, the transaction was structured in contravention of Congress's desire that nonrecognition treatment only apply to transactions where a taxpayer can be viewed as merely continuing his investment.

Musa, (CA 7 4/26/2017) 119 AFTR 2d ¶ 2017-706.

The Court of Appeals for the Seventh Circuit has affirmed the Tax Court's finding that the "duty of consistency" prevented an employer from receiving an income tax deduction for wages that he paid but did not report on any income or employment tax return until he reported them on an amended employment tax return that was filed after the expiration of the statute of limitations (SOL) for assessing employment tax on the wages. The Court also approved of the Tax Court's allowing IRS to make the duty of consistency argument in an amended answer.

The duty of consistency is an equitable tax doctrine analogous to judicial estoppel, which prevents a party from prevailing in a court proceeding by taking one position and then taking a contradictory position in a later case. The duty of consistency applies when there have been: (1) a representation or report by the taxpayer; (2) on which IRS has relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm IRS. (*Kielmar,* (CA 7 1989) 64 AFTR 2d 89-5677)

Rule 41(a) of the Rules of Practice and Procedure of the Tax Court provides: "A party may amend a pleading once as a matter of course at any time before a responsive pleading is served...Otherwise a party may amend a pleading only by leave of Court or by written consent of the adverse party, and leave shall be freely given when justice so requires."

In general, IRS may assess an employment tax or associated penalty only within three years after the return is filed. (§6501(a))

The taxpayer, Mr. Musa, owned a restaurant during the years at issue, i.e., 2006-2010. He omitted large amounts of the restaurant's revenues on his income tax return. He also paid some of his family member employees in cash and did not report these payments on his employment tax returns.

Observation: Although the case did not say so directly, it appears that he also did not deduct these payments to his family members on his income tax return.

On August 21, 2012, IRS sent Musa a Notice of Deficiency for tax years 2006 to 2010. Musa then petitioned the Tax Court for a redetermination of his tax deficiency. On September 23, 2013, Musa responded to IRS's discovery request and provided a spread sheet listing employees who he claimed had been paid additional wages but who were not previously included in the restaurant's employment tax returns. Over the next few months, the restaurant submitted amended quarterly employment tax returns for 2006 to 2010. Based on these amended returns, Musa sought additional deductions from his income tax liabilities. Musa provided copies of these amended statements to the IRS auditor on January 10, 2014.

A month later, in a conference call with the Tax Court and Musa, IRS raised the affirmative defense of the duty of consistency. It argued that the doctrine prevented Musa from claiming new expense deductions on his income tax returns for wages paid between 2006 and 2009 because IRS had relied on those representations and because the period for assessing employment taxes on those wages had expired. IRS also made this argument in its pretrial memorandum on February 24, 2014.

Because the duty of consistency is an affirmative defense, IRS sought and was granted leave to amend its answer in March 2014. IRS also sought partial summary judgment on this defense, and the Tax Court ruled in its favor on March 27, 2014.

Musa then brought this case, challenging both the Tax Court's decision to allow IRS to amend its answer and the Tax Court's application of the duty of consistency.

The Seventh Circuit held that the Tax Court did not abuse its discretion in allowing the amendment.

The Circuit Court first noted, citing *Kramer,* (1987) 89 TC 1081, that Tax Court Rule 41(a) was derived from Rule 15(a) of the Federal Rules of Civil Procedure and that the two rules should be interpreted in a similar manner. And, it said that Civil Rule 15(a) requires courts to allow amendment unless there is a good reason-futility, undue delay, undue prejudice, or bad faith-for denying leave to amend.

The Court rejected Musa's claims that he was "unduly prejudiced" when the Tax Court permitted IRS to amend its pleading. IRS raised the issue during the February 2014 conference call, i.e., more than three months before trial, and sought leave to amend its answer more than two months before trial. This was no last-minute surprise on the part of IRS. Moreover, since Musa did not make clear in his original petition that he would seek additional deductions based on his payments of previously unreported wages, IRS had no grounds to raise the duty of consistency until it actually raised it. Musa's approach would unfairly penalize IRS for Musa's own delays and false tax returns.

The Seventh Circuit also rejected Musa's argument that the Tax Court misapplied the duty of consistency. The Court found that IRS met each of the three elements of the duty.

First, Musa made representations on the various tax forms he filed, including the restaurant's quarterly employment tax returns for 2006 to 2009 and the W-2 and W-3 forms provided to the restaurant's employees and IRS. In his initial filings, Musa represented that the restaurant paid employees the following sums in non-tip wages from 2006 to 2009, respectively: $28,248; $18,900; $30,993; and $70,890. Then in the fall of 2013, Musa amended his filings to identify additional wages that he had paid to employees but failed to report for those same years.

Second, IRS relied on the original representations because IRS assessed employment taxes based on Musa's original reports of employee wages in the restaurant's quarterly employment tax returns.

Musa argued that IRS did not rely on the employment returns because IRS should have known they were inaccurate. This is so, Musa claimed, because IRS had "all facts available to [it]" or had the "opportunity to gain such knowledge" prior to the expiration of the statute of limitations. In other words, the Court said, Musa argued that after IRS discovered his income tax fraud and he submitted amended income tax returns, IRS should have induced from the amended income tax returns that the restaurant's quarterly employment tax returns had also been incorrect.

The Court said that there was no merit to Musa's claim that IRS lost its ability to rely on Musa's employment tax returns because Musa amended his income tax returns. "Ours is a self-reporting system of taxation, and for that system to function, IRS must be able to rely on truthful reporting."

Third, failing to hold Musa to the duty of consistency would harm IRS. The assessment period for the restaurant's employment tax returns for 2006 to 2008 expired before IRS could assess additional taxes based on the amended employment tax returns. Since IRS could not collect additional taxes based on Musa's amended employment tax returns, it was harmed.

Nacchio, (CA FC 6/10/2016) 117 AFTR 2d 2016-2070, cert denied 6/12/2017.

The Supreme Court has declined to review a decision of the Court of Appeals for the Federal Circuit that held that §162(f) 's rule precluding a business expense deduction for fines or similar penalties paid to a government also precludes a §165 loss deduction attributable to such a payment. The Federal Circuit had also held that amounts of illegally obtained income that were forfeited to the U.S. government under the relevant federal criminal law were penalties that precluded a §165 deduction, notwithstanding that the Justice Department was permitted to, and did, transfer the forfeited funds to victims under that law.

Under §162(a), a taxpayer can deduct all the ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business. However, §162(f) prohibits a deduction under §162(a) for any fine or similar penalty paid to a government for the violation of any law.

Under §165, taxpayers may deduct any loss sustained during the tax year and not compensated for by insurance or otherwise. For an individual, the §165 deduction includes losses incurred in any transaction entered into for profit, even if not connected with a trade or business. (§165(c)(2))

§1341, the "claim of right" doctrine, confers certain tax benefits to a taxpayer if the taxpayer establishes that: (1) an item was included in gross income for a prior tax year (or years) because it appeared that the taxpayer had an unrestricted right to such item; and (2) a deduction in excess of $3,000 is allowable for the current tax year because it was established after the close of such prior tax year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item.

Joseph Nacchio was convicted of insider trading. As a result of the conviction, he had to serve 72 months in prison, pay a $19 million fine, and forfeit $44.6 million of net income that he derived from insider trading and that he had reported as taxable income in an earlier year.

At the conclusion of his sentencing hearing, Nacchio's attorney inquired whether the court would direct that the forfeited money go to a fund set up for distribution to Nacchio's victims. Such a treatment was permitted under the "remission" provisions of the Civil Asset Forfeiture Reform Act of 2000. In response, the prosecutor advised the court that "the Government's intention is for...the forfeiture funds...to be used to compensate victims," and, ultimately, the forfeited funds were remitted to the victims.

Thereafter, Nacchio sought benefits under §1341. IRS found, however, that Nacchio's forfeiture was "the payment of a penalty for a violation of the law and, unlike restitution, is not remedial in nature," so a deduction was not permitted under any section of the Code, including §165(c)(2). IRS held that, as a result, he did not meet the requirements of §1341.

Nacchio then brought suit for a refund. The Court of Federal Claims (*Nacchio,* (Ct Fed Cl 2014) 112 AFTR 2d 2014-1288) held that Nacchio's forfeiture payment was deductible under §165. First, it noted that the government did not dispute that Nacchio's forfeiture was a loss under §165. Second, it found that the public policy against insider trading did not prevent the deduction of the amount forfeited here. The court reasoned that "disallowing the deduction would result in a "double sting" by requiring taxpayers to both make restitution and pay taxes on income they did not retain." The court expressly rejected the government's argument that deduction of the forfeiture was barred by §162(f). The court's rationale was that, unlike the $19 million fine, which was clearly punitive and was paid from assets unrelated to insider trading, the forfeiture "exclusively represented the disgorgement of Mr. Nacchio's illicit net gain from insider trading." In addition, the court found that Nacchio's forfeiture was used for a compensatory purpose because, even if not characterized as restitution, the amounts paid ultimately were returned to victims of Nacchio's crimes.

The court rejected Nacchio's attempt to deduct his forfeiture under §162 as an "ordinary and necessary business expense."

The Circuit Court held that §162(f) applies for purposes of determining whether a deduction may be claimed under §165(c)(2) and that, as a result, in this case, Nacchio could not deduct the $44.6 million under §165(c)(2).

The Court said that it agreed with the parties that §165 is subject to a "frustration of public policy" doctrine. Under this doctrine, a taxpayer cannot deduct a loss where its allowance "would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof." (*Tank Truck Rentals,* (S Ct 1958) 1 AFTR 2d 1154) And, the Court said that it agreed with IRS that, before the promulgation of §162(f), the deduction of trade or business expenses under §162(a) was limited by the same public policy doctrine that precluded loss deductions under §165 when their allowance would frustrate sharply defined public policies.

Although the promulgation of §162(f) did not explicitly affect §165, the "frustration of public policy" doctrine has continuing vitality with respect to §165. The Court cited *Stephens,* (CA 2 1990) 66 AFTR 2d 90-5147 ("Although Tellier and Tank Truck Rentals were both decided pursuant to Tax Code provisions relating to business expenses, the test for nondeducibility enunciated in those opinions is applicable to loss deductions under §165.") and Medeiros, (1981) 77 TC 1255 ("we cannot ascribe to Congress the intent, in enacting §162(f), to disallow the deduction of this penalty under §162(a) but to allow it as a loss deduction under §165 "). The Court here said that "the Stephens Court, thus, looked to §162(f) when interpreting the scope of permissible loss deductions under §165. We do the same."

The question then came down to whether Nacchio's criminal forfeiture was a "fine or similar penalty" under §162(f).

The Court said that, although it had not considered that precise question, other courts of appeals had done so, repeatedly concluding that forfeitures of property to the government similar to the one at issue are not deductible because they are punitive. For example, in *Wood,* (CA 5 1989) 63 AFTR 2d 89-709, the Fifth Circuit denied a loss deduction under §165 for the civil forfeiture of proceeds from the taxpayer's drug trafficking activities. The taxpayer pled guilty to conspiracy to import marijuana and was sentenced to prison and a fine. He argued that, because he already paid his criminal debt by means of imprisonment and the fine, he should not have to pay taxes on proceeds he forfeited to the government. But, the Wood court found that his "forfeiture cannot seriously be considered anything other than an economic penalty for drug trafficking."

Nacchio argued, however, that the fact that the forfeited funds made their way to the victims of the crimes meant that the forfeiture was tantamount to restitution. He argued that the remission process by which the funds were distributed to the victims is governed by the Civil Asset Forfeiture Reform Act, which has a compensatory purpose: to restore forfeited assets to victims of the offense giving rise to the forfeiture.

But the Court said that the Justice Department's post-hoc decision to use the forfeited funds for remission did not transform the character of the forfeiture so that it was no longer a "fine or similar penalty" under §162(f). The decision to use the forfeited funds to compensate the victims was discretionary. Allowing Nacchio to deduct his forfeiture because the Justice Department decided to distribute it to victims through remission would mean that whether two people convicted of the same crimes could deduct their criminal forfeiture would turn not on their actions, or the statutes governing their sentencings, but on the after-the-fact discretionary decisions of a third party. The Court said, "That is not the law."

Because the forfeited moneys did not qualify for deduction under any Code section, the §1341 benefits were not available to Nacchio.

On June 12, 2017, the Supreme Court refused to review the Federal Circuit's decision. Accordingly, that decision is now final.

Palmolive Building Investors, LLC, (2017) 149 TC No. 18

The Tax Court has denied a taxpayer's charitable contribution deduction, concluding its easement deed failed to satisfy the "in perpetuity" requirement of §170(h)(5).

In general, the Code bars a charitable contribution deduction for a contribution of an interest in property that is less than the taxpayer's entire interest in the property, but an exception is made for a qualified conservation contribution, i.e., the contribution of a qualified real property interest exclusively for conservation purposes. (170(f)(3))

For a contribution to be deemed exclusively for a conservation purpose, that purpose must be protected in perpetuity. (§170(h)(5)(A) , Regulation § 1.170A-14(b)(2)) Any interest in the property retained by the donor must be subject to legally enforceable restrictions that will prevent uses of the retained interest inconsistent with the conservation purposes of the donation. (Regulation § 1.170A-14(g)(1)) No deduction is permitted for an interest in property which is subject to a mortgage, unless the mortgagee subordinates its rights in the property to the right of the donee organization. (Regulation § 1.170A-14(g)(2))

Regulations provide that at the time of the gift, the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee organization, with a fair market value that, at the time of the gift, is at least equal to the proportionate value that the perpetual conservation restriction bears to the value of the property as a whole. When a change in conditions results in the extinguishment of a perpetual conservation restriction, the donee organization, on a subsequent sale, exchange, or involuntary conversion of the property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction. (Regulation § 1.170A-14(g)(6)(ii))

Regulation § 1.170A-14(h)(3)(i) provides that the value of the contribution is the fair market value of the perpetual conservation restriction at the time of the contribution. If there is no substantial record of sales of easements comparable to the donated easement, generally the fair market of the donated restriction is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction.

In *Kaufman v. Commissioner,* (CA 1 4/24/2015) 115 AFTR 2d 2015-1629 , the First Circuit, affirming the Tax Court, held that taxpayers were liable for the substantial valuation misstatement penalty for an underpayment caused by a deduction for the charitable contribution of an easement. The donation of the façade preservation easement that the taxpayers granted to an exempt organization had no value because the façade was already subject to similar restrictions as a result of the property being in a historic district.

In 2004, Palmolive Building Investors, LLC (Palmolive) transferred a facade easement by executing an easement deed in favor of a qualified organization. The easement deed placed restrictions on Palmolive and its successors with respect to the facade easement and the building. Palmolive's building was subject to two mortgages, but before executing the easement deed, Palmolive obtained ostensible mortgage subordination agreements from its mortgagee banks. However, the easement deed provided that in the event the facade easement is extinguished through a judicial proceeding, the mortgagee banks will have claims prior to that of the donee organization to any proceeds received from the condemnation proceedings until the mortgage is satisfied. The easement deed also contained a saving clause that would apply to retroactively reform the deed to comply with IRS regs (if the mortgagee consented).

For 2004, Palmolive claimed a charitable contribution deduction for the facade easement contribution.

In a notice of final partnership administrative adjustment issued to Palmolive, IRS disallowed Palmolive's claimed charitable contribution deduction for the donation of the facade easement. IRS also determined that it was liable for a gross valuation misstatement penalty under §6662(h) and §6662(a) , or alternatively for a substantial understatement of income tax, negligence or disregard of rules or regulations, or a substantial valuation misstatement penalty under §6662(a) and §6662(b)(1) , §6662(b)(2) or §6662(b)(3) .

Palmolive's tax matters partner (TMP) filed a petition in this Court challenging these determinations, and IRS filed a motion for partial summary judgment.

IRS argued that the easement deed did not satisfy the perpetuity requirements of §170 and Regulation § 1.170A-14(g)(6)(ii) because it provided the mortgagees with prior claims to extinguishment proceeds in preference to the donee.

On the other hand, Palmolive argued to the contrary, citing Kaufman. Alternatively, Palmolive argued that if the easement deed did not otherwise violate the perpetuity requirement of §170 and the regulations, the easement deed contained a saving clause that would retroactively reform the deed to comply with the perpetuity requirements of Regulation § 1.170A-14(g)(6)(ii) .

The Tax Court found that Palmolive's easement deed failed to satisfy the "in perpetuity" requirement of §170(h)(5) because: (1) the mortgages on the building were not fully subordinated to the easement as required by Regulation § 1.170A-14(g)(2) ; and (2) the donee was not guaranteed to receive the share of proceeds mandated by Regulation § 1.170A-14(g)(6)(ii) in the event that the easement was extinguished and the donor subsequently conveyed the property and received proceeds for it. Thus, the facade easement contribution was not a qualified conservation contribution under §170(h) , and Palmolive was not entitled to a charitable contribution deduction.

The Court also determined that, in this case, presumably appealable to the Seventh Circuit, the Tax Court was not bound by the opinion of the First Circuit in Kaufman. The Tax Court concluded that it would not follow that decision.

Further, the Tax Court held that the defects in the easement deed were not cured by a provision that purported to retroactively amend the deed because the requirements of §170 must be satisfied at the time of the gift.

Partita Partners LLC, et al v. U.S., (DC NY 7/10/2017) 120 AFTR 2d ¶ 2017-5042.

A district court, denying a taxpayer's summary judgment motion, has concluded that a gross valuation is not precluded by the fact that a court had previously denied the taxpayer's deduction in full because it failed to meet the requirements for a charitable contribution of a façade preservation easement.

In general, §170(f)(3) bars a charitable contribution deduction for a contribution of an interest in property that is less than the taxpayer's entire interest in the property, but an exception is made for a qualified conservation contribution, i.e., the contribution of a qualified real property interest exclusively for conservation purposes. (§170(h))

A contribution of a qualified real property interest that's a restriction relating to the exterior of a building located in a registered historic district and certified as being of historic significance to the district (e.g., a façade easement) must meet several requirements in order to be considered to be "exclusively for conservation purposes." One such requirement is that the easement preserve "the entire exterior of the building (including the front, sides, rear, and height of the building)." (§170(h)(4)(B)(i)) Another requirement is that any change in the exterior of the building inconsistent with its historical character be prohibited. (§170(h)(4)(B)(ii))

Taxpayers are subject to a 20% accuracy-related penalty for an underpayment of tax required to be shown on a return that is attributable to a substantial valuation misstatement. (§6662(a), §6662(b)(3)) The penalty is 40% of the portion of an underpayment of tax attributable to one or more substantial valuation misstatements that meet the requirements for a gross valuation misstatement. (§6662(h)) A substantial valuation misstatement exists if the value of any property (or the adjusted basis of any property) claimed on any tax return is 150% or more of the amount determined to be the correct amount of such valuation or adjusted basis. (§6662(e)(1)(A)) A gross valuation misstatement exists if the value or adjusted basis of any property claimed on a tax return is 200% or more of the amount determined to be the correct amount of such value or adjusted basis. (§6662(h)(2)(A))

The *Supreme Court in U.S. v. Woods,* (S Ct 12/3/2013) 112 AFTR 2d 2013-6974, resolving a split in the circuits, held that the §6662(e) valuation misstatement penalty could be imposed where the underlying transaction lacked economic substance. In Woods, a partnership engaged in sham transactions by which the partners claimed a high outside basis in the partnership, thus facilitating deductions for significant losses. IRS concluded that the partnerships were formed solely for purposes of tax avoidance, disallowed the deductions, and imposed a 40% penalty for gross valuation misstatements.

In *Woods,* the taxpayer argued that because the partnerships themselves were deemed to be shams, the underpayment of taxes could not be "attributable" to a valuation misstatement. The Supreme Court disagreed, and concluded that because the existence of the sham tax shelters was intertwined with inaccurate claims of high basis and their attendant deductions, a valuation misstatement of basis was inherently part of the sham. The Court also stated "that the valuation-misstatement penalty encompasses legal as well as factual misstatements of adjusted basis."

In 2008, Partita Partners LLC (Partita) claimed a federal tax deduction of $4,186,000 for the donation of a preservation easement in the façade of a building that was constructed in the 1870s. Partita made its donation to the Trust for Architectural Easements, and, as part of its deed of easement, reserved 2,700 square feet for future development rights.

In 2014, IRS disallowed the deduction and assessed an underpayment penalty of 40%, asserting that Partita had made a gross valuation misstatement. In the alternative, IRS assessed an underpayment penalty of 20% on grounds of negligence, substantial understatement of income tax, or a substantial valuation misstatement.

Partita filed suit, asserting that its taxes should be readjusted to recognize the charitable deduction of the façade easement donation and that no underpayment penalty should be imposed.

On October 25, 2016, the district court granted IRS partial summary judgment, concluding that, as a matter of law, Partita's donation of the façade easement did not preserve the building's entire exterior as required by §170(h)(4)(B). Accordingly, Partita was ineligible for the $4,186,000 deduction that it claimed. (*Partita Partners LLC v. U.S.*, (DC NY 10/25/2016) 118 AFTR 2d 2016-6243)

The issue of Partita's challenge to the underpayment penalties remained to be determined.

Partita argued that, as a matter of law, it did not make a valuation misstatement when it claimed a deduction for the easement donation. It contended that the 2008 underpayment was not attributable to a valuation misstatement because the deduction was disallowed on entirely separate grounds that were not related to valuation.

The district court held that IRS's successful court challenge to Partita's charitable deduction did not preclude it from continuing to litigate the taxpayer's underpayment penalties, which had not been previously decided.

The district court noted that courts have upheld the use of a valuation misstatement penalty when the taxpayer's claimed deduction was denied in its entirety because it lacked a foundation in fact or law. Such cases typically involved the use of tax shelters or accounting schemes whereby businesses or individuals purposefully engaged in sham transactions solely for tax benefits. These cases stood in contrast to the "paradigmatic case" in which the taxpayer overstated the value of a deduction. Where such transactions had no legitimate business purpose or economic substance, IRS has denied deductions in their entirety, and its imposition of a valuation misstatement penalty has been upheld. See *Gilman v. Commissioner,* (CA 2 1991) 67 AFTR 2d 91-1016.

In support of its motion, Partita relied on a pre-Woods line of authority, which held that a valuation misstatement penalty could not be imposed where an underlying deduction was disallowed in its entirety on grounds other than a valuation misstatement. See *Todd v. Commissioner,* (CA 5 1988) 63 AFTR 2d 89-523. As Woods noted, other courts were in near-unanimous opposition to that minority interpretation. Woods expressly abrogated it, and the district court here declined to follow Todd and its progeny.

The district court also rejected Partita's attempt to distinguish Woods. In Woods, the valuation misstatements relating to partnership basis were intertwined with the underlying sham transactions. Here, Partita argued, the disallowed $4,186,000 charitable deduction was not intertwined with a valuation misstatement of that same amount. The district found that the language of §6662(b) and Second Circuit authority (such as *Irom v. Commissioner,* (CA 2 1989) 63 AFTR 2d 89-644) did not preclude the penalty's application when a deduction was also disallowed on other, separate grounds.

The district court also rejected the taxpayer's contention that the underpayment at issue was not "attributable" to a valuation misstatement. IRS observed that the term "is attributable to" does not mean "was attributed to," and that §6662 contemplates that there may be more than one reason for a taxpayer's underpayment. In interpreting a similar, since-repealed penalty statute, the Second Circuit in Irom observed that the ordinary, dictionary meaning of "attributable" is "capable of being attributed." Though it involved a different penalty statute, the district court found Irom's interpretation of the word "attributable" to be persuasive.

Partita Partners LLC v. U.S., (DC NY 10/25/2016) 118 AFTR 2d ¶2016-5353.

A district court has upheld IRS's denial of a partnership's $4.2 million deduction for its charitable donation of a façade preservation easement on a building located in a historic district. The easement, which reserved the right to undertake additional construction on the property, failed to preserve the "entire exterior" of the building, as required by §170(h)(4)(B).

In general, §170(f)(3) bars a charitable contribution deduction for a contribution of an interest in property that is less than the taxpayer's entire interest in the property, but an exception is made for a qualified conservation contribution, i.e., the contribution of a qualified real property interest exclusively for conservation purposes. (§170(h))

A contribution of a qualified real property interest that's a restriction relating to the exterior of a building located in a registered historic district and certified as being of historic significance to the district (e.g., a façade easement) must meet several requirements in order to be considered to be "exclusively for conservation purposes." One such requirement is that the easement preserve "the entire exterior of the building (including the front, sides, rear, and height of the building)." (§170(h)(4)(B)(i)) Another requirement is that any change in the exterior of the building inconsistent with its historical character be prohibited. (§170(h)(4)(B)(ii))

In 2003, Partita Partners LLC (Partita) purchased a building at 964-966 Lexington Avenue in New York City, for a price of $4,050,000. The building is a 4-story walk-up that was constructed in the 1870s. It has been designated as part of the Upper East Side Historic District since 1981.

In 2007, E. William Judson, a managing member of Partita, met with a representative of the Trust for Architectural Easements (TAE) to discuss donating an easement in the building's façade to the TAE. In 2008, Judson signed a "Historic Preservation Deed of Easement," which provided that 2,700 square feet of development rights associated with the property were reserved for future expansion. The Deed of Easement essentially permitted Partita to undertake additional construction on the property, conditioned on the TAE's approval. Judson testified in his deposition that the development rights were reserved to add "a couple of floors, two or three floors on the roof" and to potentially extend the ground floor of the structure.

Based on its donation of the easement to the TAE, Partita claimed a charitable deduction of $4.2 million on its 2008 federal tax return, which IRS disallowed.

The district court concluded that, based on the plain, unqualified statutory language, a contribution must include a restriction preserving the "entire exterior" of the building in order for the contribution to be considered exclusively for conservation purposes. (§170(h)(4)(B)(i))

The court rejected Partita's argument that the parenthetical description of the exterior of a building as "including the front, sides, rear, and height of the building" in §170(h)(4)(B)(i) was limited solely to those features. The Code itself expressly provides that the term "including" does not "exclude other things otherwise within the meaning of the term defined." (§7701(c)) In addition, the TAE advised Partita of this limitation in a disclosure notice that Judson signed before executing the Deed of Easement. The court also dismissed Partita's argument that a deduction should be allowed if the rooftop construction does not exceed the height of the bulkhead that currently exists on the roof, noting that this argument was unsupported by the statute. Finally, the court found that the absence of regulatory guidance on §170(h)(4)(B)(i) does not lend any support to Partita's argument.

Having determined that "entire exterior" is unambiguous and unqualified, the court found that the easement, which reserved to Partita the right to undertake additional construction and expansion of the property with the TAE's approval, was not made "exclusively for conservation purposes." Judson testified that the reserved development rights were intentional, that he intended to add additional floors and expand the ground floor, and that he did not want the easement to interfere with his ability to do so-which the court found inconsistent with the statutory mandate to preserve the entire exterior of the property.

The court also rejected Partita's argument that any construction or improvements would be unlikely to alter the existing exterior since they required the TAE's approval. The court stated that §170(h)(4)(B)(i) requires a restriction preserving the entire exterior of the building, and not "a conditional restriction that delegates to the grantee future decisions on development of the exterior."

Petersen, (2017) 148 TC No. 22.

The Tax Court, in a case of first impression, has determined that the entity holding stock of an S corporation for the benefit of participants in the S corporation's employee stock ownership plan (ESOP) was a trust for purposes of §267(c), and that the stock was thus deemed to be held by the trust's beneficiaries, i.e., the ESOP participants. Accordingly, the ESOP participants and S corporation were "related" under §267(b), so the S corporation was required to defer its deductions, for certain accrued but unpaid payroll expenses, to the year in which such pay was received by the ESOP participants and includible in their gross income.

Generally, an accrual basis taxpayer may deduct ordinary and necessary business expenses in the year when all events have occurred that establish the fact of the liability, the amount of the liability is set, and economic performance has occurred with respect to the liability. (§461; Regulation §1.446-1(c)(1)(ii)(A))

When such expenses are owed to a related cash basis taxpayer, however, §267(a)(2) provides that the payor may deduct the expenses only for the tax year for which the amounts are includible in the payee's gross income. As described by the Tax Court, §267 is designed "to prevent the use of the differing methods of reporting income for Federal income tax purposes in order to obtain artificial deductions for interest and business expenses." (*Metzger Trust,* (1981) 76 TC 42, aff'd (CA 5 1982) 51 AFTR 2d 83-376))

§267(b) generally defines "relationships" that implicate §267. Under §267(e), an S corporation and any person who owns, directly or indirectly, any stock in the corporation are "persons specified in" §267(b), regardless of how much or how little stock each shareholder individually owns. §267(c) provides constructive ownership rules to determine whether the related party rules apply. As relevant here, §267(c)(1) provides that "[s]tock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries."

Petersen, Inc. is a closely held S corporation incorporated in 1980 of which the taxpayers, the Petersens and Johnstuns, were shareholders and original owners. Petersen uses the accrual method of accounting for Federal income tax purposes. In 2001, Petersen formed an ESOP for the benefit of its employees, including the taxpayers, and transferred S stock and cash to the related ESOP trust. The ESOP documents included a plan agreement and a trust instrument.

During 2009 and 2010, Petersen accrued payroll expenses (wages, vacation pay, and other payroll items) for employees who participated in the ESOP, but a portion of these expenses remained unpaid at the end of each year. Petersen claimed deductions, and its shareholders claimed flowthrough deductions, for these accrued but unpaid payroll expenses.

IRS disallowed these deductions on the ground that the ESOP participants were beneficiaries of a "trust"; that these employees were deemed by §267(c) to be constructive owners of the S stock held by the trust; and hence that the ESOP participants and Petersen were related persons for purposes of §267(b) and §267(a)(2). IRS also imposed accuracy-related penalties under §6662.

The sole issue before the Tax Court was whether Petersen and the ESOP participants were related persons under §267(b). This, in turn, required determining whether the Petersen stock was owned by a "trust" (and thus considered owned by the taxpayers under §267(c)(1)).

The Court, looking to the plain language of the statute, found that the entity holding the Petersen stock for the benefit of the ESOP participants was a "trust" of which the ESOP participants were beneficiaries. While §267 does not define a "trust," the Court found that the term was used in a broad and unqualified way and that, looking at the operative documents and facts of this case, the entity was clearly a trust. The trust document provided for, among other things, the establishment of a trust for the benefit of the ESOP participants, the contribution of property to the trust, and the designation of a trustee to hold the property for the beneficiaries and act in their best interest. In addition, the Court also noted that the statutory scheme underlying the ESOP arrangement in this case "presumes that the stock held for the benefit of the ESOP participants will be owned by a trust.

The taxpayers asserted a number of challenges to the Court's characterization of the entity as a trust, all of which the Court found unconvincing. The Court rejected the taxpayers' claim that Petersen's right to terminate the plan gave it a reversionary interest, finding such contrary to the trust instrument, and also rejected their argument that the entity was not a "trust" under Utah law, noting that federal law supersedes state law in construing §267(c)(1) -a federal statute.

In addition, the taxpayers also argued that an ESOP, as a matter of law, cannot be a "trust" under §267(c)(1). However, the Court readily dismissed their arguments, saying that they "fail to appreciate the distinction between the plan agreement, which created the ESOP, and the trust instrument, which created the trust that holds the plan assets." These arguments included that the term "trust" in §267(c)(1) should be limited to common law trusts, thus excluding ESOPs as such are "creatures of statute," and that the ESOP trust was not a legally distinct trust entity.

The Tax Court also rejected the taxpayers' argument that §318 (which explicitly excludes tax-exempt employee trusts from its constructive ownership rules), not §267, provided the applicable rules for determining constructive ownership in this case. The Court found that §267 provides its own constructive ownership rules in §267(c), and that §318, which is in a different subchapter, is not "expressly made applicable" by §267.

Accordingly, since the Petersen stock held by the trust was owned by the ESOP participants, rendering the participants "related persons" under §267(b), Petersen's deductions for the accrued but unpaid payroll expenses were deferred to the year in which such pay was received by the ESOP participants and includible in their gross income.

The Court, however, declined to impose an accuracy-related penalty against the taxpayers, finding that they made a good faith effort to properly assess their tax liabilities. The Court noted that the application of §267(a) to employers and ESOP participants was an issue of first impression and that it has previously declined to impose a penalty "where it appeared that the issue was one not previously considered by the Court and the statutory language was not entirely clear." (*Hitchins,* (1994) 103 TC 711)

RP Golf v. Commissioner, (CA 8 06/26/2017) 119 AFTR 2d ¶2017-899.

The Court of Appeals for the Eighth Circuit, affirming the Tax Court, has denied a taxpayer a qualified conservation contribution deduction for property subject to two mortgages. The taxpayer claimed that it had entered into an oral agreement with the mortgagees to subordinate their rights to the property, but the Court found that there was insufficient evidence to show that such an agreement existed and that the contribution therefore was not "protected in perpetuity."

In general, the Code bars a charitable contribution deduction for a contribution of an interest in property that is less than the taxpayer's entire interest in the property, but an exception is made for a qualified conservation contribution, i.e., the contribution of a qualified real property interest exclusively for conservation purposes. (§170(f)(3))

For a contribution to be deemed exclusively for a conservation purpose, that purpose must be protected in perpetuity. (§170(h)(5)(A), Regulation §1.170A-14(b)(2)) Any interest in the property retained by the donor must be subject to legally enforceable restrictions that will prevent uses of the retained interest inconsistent with the conservation purposes of the donation. (Regulation §1.170A-14(g)(1)) No deduction is permitted for an interest in property which is subject to a mortgage, unless the mortgagee subordinates its rights in the property to the right of the donee organization. (Regulation §1.170A-14(g)(2))

In *Mitchell,* (CA 10 01/06/2015) 115 AFTR 2d 2015-346, the Tenth Circuit, affirming the Tax Court (Mitchell, (2012) 138 TC 324), upheld IRS's disallowance of a qualified conservation contribution deduction for property subject to a mortgage, where the mortgagee's rights were not subordinated to those of the donee organization on the date of the gift. The Tenth Circuit agreed with the Tax Court that a subordination agreement signed almost two years after the grant of the easement did not satisfy the subordination requirement. The Ninth Circuit reached a similar conclusion in *Minnick,* (CA 9 2015) 116 AFTR 2d 2015-6609, where there was a nearly 5-year gap between an easement's conveyance and subordination.

RP Golf was a limited liability company (LLC) and the sole member of National Golf, a single-member LLC disregarded for tax purposes.

On December 29, 2003, National Golf executed an agreement granting a conservation easement to the Platte County Land Trust (PLT), a not-for-profit corporation. The property underlying the easement covered about 277 acres, on which National Golf operated two private golf courses. Under the agreement terms, National Golf agreed to incorporate the terms of the easement by reference in any deed or other legal instrument by which it divested itself of any interest in all or a portion of the property.

On the date the conservation easement was granted, the property was subject to senior deeds of trust held by Great Southern Bank and Hillcrest Bank. Neither bank joined in or otherwise acknowledged the PLT agreement. The original Hillcrest loan was made in 2001 for $12.5 million and contained standard provisions prohibiting any transfer of any interest in the property without the consent of the Hillcrest Bank.

On April 14, 2004, Great Southern Bank and Hillcrest Bank officials executed consents to subordinate the interests of the banks to PLT-over 100 days after the PLT agreement and on the same date as RP Golf's 2003 tax return. The consents to subordinate were recorded in the Platte County Recorder's Office on April 15, 2004. While the PLT agreement was executed by National Golf on December 29, 2003, and recorded on December 30, 2003, each consent stated that the subordination was made effective as of December 31, 2003.

RP Golf claimed a $16.4 million charitable contribution deduction on its 2003 return. IRS challenged the deduction on the basis that the donated property was not protected in perpetuity by virtue of the banks' recorded deeds of trust on the subject property. IRS reasoned that, because the easement could have been extinguished by foreclosure between December 29, 2003 and April 15, 2004, it was not protected in perpetuity. RP Golf, however, argued that the banks had orally subordinated their interests at the time of the contribution, and they later put this agreement in writing, so the perpetuity requirement was met.

Tax Court sided with IRS. The Tax Court found that RP Golf failed to meet the §170 requirements for a noncash charitable contribution of a qualified conservation contribution because the property described in the PLT agreement was subject to preexisting, unsubordinated mortgages on the date of the grant. Accordingly, RP Golf's charitable contribution deduction was decreased by the $16.4 million. The Tax Court found that the evidence did not establish the oral consent agreements that RP Golf claimed to have reached with the banks on the subordination of their interests in the easement property on or before December 29, 2003, the date of the PLT agreement. The Tax Court's decision that RP Golf failed to prove the existence of the oral subordination agreements was based on, among other things, its finding that RP Golf's representative lacked credibility. Therefore, because the easement granted by National Golf could have been extinguished by foreclosure between December 29, 2003 and April 15, 2004, it was not protected in perpetuity. (*RP Golf,* TC Memo 2016-80)

RP Golf appealed, arguing that it met the "protected in perpetuity" requirement even though the subordination did not occur until after the conveyance. RP Golf claimed that the Code does not require that a mortgage be subordinated at the time of conveyance in order to claim a deduction.

The Court of Appeals for the Eighth Circuit affirmed the Tax Court. The Eighth Circuit found that RP Golf's argument had already been rejected by the Ninth and Tenth Circuits (see *Minnick* and *Mitchell*), which concluded that a plain reading of Regulation §1.170A-14(g)(2) requires subordination as a prerequisite to allowing a deduction. The Eighth Circuit further found that, even if that regulation were ambiguous in terms of when the mortgage must be subordinated, IRS's interpretation of it as requiring subordination in advance of the conveyance was reasonable.

RP Golf also challenged the Tax Court's determination that there was insufficient evidence to show that the banks had orally agreed to subordinate their interests in the property, asserting that such was not a "finding of fact" because it appeared in the "Opinion" section of the Tax Court's decision. The Eighth Circuit, however, found that where the determination appeared in the decision, and how it was labelled, were "of no significance." The Appellate Court said that the Tax Court made a factual finding that the evidence did not establish that there were oral agreements based in part on the credibility of RP Golf's representative, and that its finding was not clearly erroneous. The Eighth Circuit also generally noted that a fact finder's credibility determination can "virtually never be considered clearly erroneous." (*Anderson v. City of Bessemer City,* (S Ct 1985) 470 U.S. 564)

Reri Holdings I, LLC, Jeff Blau, Tax Matters Partner, (2017) 149 TC No. 1.

A partnership was not entitled to a charitable contribution deduction for the remainder interest that it contributed to a tax-exempt organization because it failed to comply with the substantiation requirements of Regulation §1.170A-13(c). In addition, the Court determined the claimed charitable contribution deduction resulted in a gross valuation misstatement.

Regulation §1.170A-13(c) provides substantiation requirements that apply to a deduction for charitable contributions of property worth more than $5,000. Failure to satisfy these requirements results in denial of a deduction for the contribution. (§170, Regulation §1.170A-13(c)(1)(i)) To meet the requirements, the donor must obtain a qualified appraisal of the contributed property, attach a "fully completed" appraisal summary to the return on which the deduction is first claimed, and maintain records containing specified information. (Regulation §1.170A-13(c)(2)(i)(A), Regulation §1.170A-13(c)(2)(i)(B), Regulation §1.170A-13(c)(2)(i)(C)) The required appraisal summary must provide, among other things, the adjusted cost or other basis of the donated property. (Regulation §1.170A-13(c)(4)(ii)(E))

Taxpayers are subject to a 20% accuracy-related penalty for an underpayment of tax required to be shown on a return that is attributable to a substantial valuation misstatement. (§6662(a), §6662(b)(3)) The penalty is 40% of the portion of an underpayment of tax attributable to one or more substantial valuation misstatements that meet the requirements for a gross valuation misstatement. (§6662(h)) A gross valuation misstatement exists if the value or adjusted basis of any property claimed on a tax return is 200% (400% under a prior, pre-amended version of this provision that was applicable to this taxpayer's case) or more of the amount determined to be the correct amount of such value or adjusted basis. (§6662(h)(2)(A)) Whether there is a gross valuation misstatement in the partnership context is determined at the partnership level. (Regulation §1.6662-5(h)(1))

§6664(c) provides an exception to the accuracy-related (and fraud) penalties if there was reasonable cause for the portion of the underpayment subject to the penalty and the taxpayer acted with good faith with respect to that portion. The reasonable cause exception does not apply to a substantial or gross valuation misstatement arising from a claimed charitable contribution deduction unless the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, (§6664(c)(3)(A)) and the taxpayer made a good faith investigation of the value of the contributed property. (§6664(c)(3)(B))

In most valuation cases, the willing buyer-willing seller standard is not applied directly to annuities, life estates, terms of years, remainders, reversions, and similar partial interests in property. Instead, those interests are generally valued under tables prescribed by IRS that divide the fair market value of the underlying property among the several interests in the property on the basis of their present values, determined using a prescribed interest rate. (§7520(a))

For income, estate and gift tax purposes, a standard §7520 remainder interest factor for an ordinary remainder or reversionary interest cannot be used to determine the present value of a remainder or reversionary interest (whether in trust or otherwise) unless, consistent with the preservation and protection that the law of trusts provides for a person who is unqualifiedly designated as the remainder beneficiary of a trust for a similar duration, the effect of the administrative and dispositive provisions for the interest or interests that precede the remainder or reversionary interest is to assure that the property will be adequately preserved and protected from erosion, invasion, depletion, or damage until the remainder or reversionary interest takes effect in possession and enjoyment. This degree of preservation and protection is provided only if it was the transferor's intent, as manifested by the provisions of the arrangement and the surrounding circumstances, that the entire disposition provide the remainder or reversionary beneficiary with an undiminished interest in the property transferred at the time of the termination of the prior interest. (Regulation §1.7520-3(b)(1)(iii))

Reri Holdings I, LLC (Reri Holdings), a partnership, paid $2.95 million in March of 2002 to acquire a remainder interest in property. The agreement that created the remainder interest provided covenants intended to preserve the value of the subject property but also limited the remedy available to the holder of the remainder interest for a breach of those covenants to immediate possession of the property. In no event would the holder of the corresponding term interest be liable for damages to the holder of the remainder interest.

On August 27, 2003, Reri Holdings assigned the remainder interest to University.

On its 2003 Form 1065, U.S. Return of Partnership Income, Reri Holdings claimed a $33,019,000 charitable contribution deduction under §170(a)(1). The Form 8283, Noncash Charitable Contributions, that it attached to its return provided the date and manner of its acquisition of the contributed remainder interest but left blank the space for the "Donor's cost or other adjusted basis."

The Tax Court held that Reri Holdings' failure to comply, either strictly or substantially, with the requirements of Regulation §1.170A-13(c)(2) required a denial in full of its claimed charitable contribution deduction.

The Tax Court found that Reri Holdings' omission from its Form 8283 of its cost or other adjusted basis in the contributed remainder interest violated the substantiation requirement of Regulation §1.170A-13(c)(4)(ii)(E). Because Reri Holdings' disclosure of its cost or other basis in the contributed property would have alerted IRS to a potential overvaluation of that property, omission of that information prevented the Form 8283 from achieving its intended purpose. The omission thus could not be excused on the grounds of substantial compliance.

Because Reri Holdings did not meet the substantiation requirement provided in Regulation §1.170A-13(c)(2), the value of the property interest that it contributed to the University was irrelevant to the issue of the amount of the deduction to which the partnership was entitled for that contribution. However, the value needed to be determined to see if the value Reri Holdings claimed on its return resulted in a gross or substantial valuation misstatement.

On the basis of all of the facts and circumstances, the Tax Court determined that the remainder interest that Reri Holdings assigned to University on August 27, 2003, had a fair market value on that date of $3,462,886. Because the $33,019,000 value that Reri Holdings assigned to the remainder interest it transferred to University was more than 400% of that interest's actual fair market value, Reri Holdings' claimed charitable contribution deduction resulted in a gross valuation misstatement under §6662(e)(1)(A) and §6662(h)(2) And, the Court found that any underpayment resulting from the disallowance of Reri Holdings' claimed charitable contribution deduction would be "attributable to" a gross valuation misstatement to the extent the underpayment relates to the disallowance of that portion of the deduction that exceeds $3,462,886. The Court reasoned that if a taxpayer claims a deduction that overstates by 200% or 400% the value or basis of property, any underpayment resulting from the disallowance of that deduction on grounds unrelated to valuation-that is, even though that disallowance resulted not from Reri Holdings' claiming a value for the property in excess of its correct value but instead from the partnership's failure to substantiate its claimed deduction-is nonetheless "attributable to" the valuation misstatement. (AHG Invs., LLC, (2013) 140 TC. 73)

Because of the limitation on remedies available to the holder of the remainder interest for breaches of protective covenants, the agreement that created that interest did not provide adequate protection to its holder, for purposes of Regulation §1.7520-3(b)(2)(iii). Accordingly, the standard actuarial factors provided under §7520 did not apply in valuing the remainder interest. Instead, the value of that interest was its "actual fair market value," determined without regard to §7520, on the basis of all of the facts and circumstances. (Regulation §1.7520-3(b)(1)(iii))

IRS also concluded that Reri Holdings did not make a good-faith investigation of the value of the property subject to the remainder interest and thus did not have reasonable cause for, or act in good faith with respect to, its claim of a charitable contribution deduction that resulted in a gross valuation misstatement under §6664(c)(3)(B).

Shea Homes, Inc. and Subsidiaries AOD 2017-03,04/13/2017.

IRS has announced its nonacquiescence with the holding of the Court of Appeals for the Ninth Circuit in Shea Homes, which affirmed the Tax Court, which concluded that taxpayers who developed large, planned residential communities had used a permissible accounting method that clearly reflected their income. The taxpayers maintained that completion and acceptance under the completed contract method of accounting under §460 did not occur until the common improvements and amenities were completed.

Under the completed contract method (CCM), gross contract price and allocable contract costs are taken into account upon contract completion. Contract completion occurs upon the earlier of: (1) the customer's use of the subject matter of the contract and taxpayer having incurred 95% of the estimated allocable contract costs attributable to the subject matter (the 95% completion test); and (2) final completion and acceptance of the subject matter. (Regulation §1.460-1(c)(3)(i)) The regulations also provide that completion is determined without regard to whether "secondary items" have been used or finally completed and accepted. (Regulation §1.460-1(c)(3)(ii))

Shea Homes, Inc. and Subsidiaries (Taxpayers) constructed and sold houses in residential developments. Taxpayers also constructed common improvements. These improvements included infrastructure, such as sewers and roads, and amenities, such as parks and clubhouses. Taxpayers entered into separate purchase and sale agreements (home construction contracts) with individual buyers. Taxpayers used the CCM set out in Regulation §1.460-4(d) to account for the income and costs of their home construction contracts.

For purposes of determining when their home construction contracts were completed, Taxpayers treated an entire development or phase of a larger development as the subject matter of each individual home construction contract. Thus, in applying the 95% completion test to a contract, Taxpayers took into account the estimated costs of the entire development or phase, including the costs of constructing houses that were the subject matter of other contracts. Taxpayers deferred recognition of income from all house sales in a development or phase until they had incurred 95% of the estimated costs of the entire development or phase.

On audit, IRS challenged this treatment and asserted that income from Taxpayers' home construction contracts should be reported at the time of sale, because that was when there was final completion and acceptance of the subject matter of the contract, or, in the alternative, at final completion and acceptance of all but uncompleted secondary items.

The Tax Court rejected IRS's arguments (1) that the subject matter of an individual home construction contract consisted solely of a house and the lot on which the house was situated, and (2) alternatively, that common improvements, although a part of each contract's subject matter, were secondary items, so that a contract was completed upon the sale of a house, when the sole or primary subject matter of the contract had been finally completed and accepted. The Tax Court found for Taxpayers. *(Shea Homes, Inc. and Subsidiaries, et al,* (2014) 142 TC 60) IRS appealed.

The Ninth Circuit affirmed the Tax Court decision. The Court stated, "[T]he Tax Court determined that, as a matter of fact, the subject matter included the house, the lot, 'the development...and its common improvements and amenities'" (quoting the Tax Court opinion).

The Court reviewed the Tax Court's conclusions of law and mixed questions of law and fact de novo (anew). A mixed question of law and fact is one in which the primary facts are undisputed and ultimate inferences and legal consequences are in dispute. The Court reviewed the Tax Court's findings of fact for clear error. The Ninth Circuit declined to reverse what it considered the Tax Court's factual finding that the subject matter of each home construction contract consisted of the entire development or phase in which a house was situated.

Accordingly, the Court held that Taxpayers' method of determining contract completion was proper. (*Shea Homes, Inc. and Subsidiaries* (CA 9 8/24/2016) 118 AFTR 2d ¶ 2016-5593)

IRS disagrees with the Ninth Circuit's conclusion that the 95% completion test can properly be applied with reference to the costs of an entire development or phase. IRS found that the Ninth Circuit reviewed the Tax Court decision under a clearly erroneous standard. The Court should not have approached its review as if was evaluating a factual finding by the Tax Court; the Court should have examined whether the Tax Court correctly interpreted and applied the applicable the Code and regulations.

In the AOD, IRS explained that its position is that, under the regulations, contract completion and the 95% completion test must apply on a contract-by-contract basis. It reasoned that the latter considers "the total allocable contract costs attributable to the subject matter [of the contract]." (Regulation §1.460-1(c)(3)(i)(A)) The total costs of an entire development or phase cannot be the "allocable contract costs" of each individual home construction contract. Regulation §1.460-4(d)(1) provides that "a taxpayer using the CCM...must take into account in the contract's completion year...the gross contract price and all allocable contract costs incurred by the completion year." If the "allocable contract costs" of a contract are the entire cost of a development or phase, this same set of costs becomes deductible multiple times as each and every individual home construction contract is completed.

Further, IRS determined that the definition of contract completion in the regulations assumes that the subject matter of a contract can be used by a customer and that the customer can accept the subject matter. (Regulation §1.460-1(c)(3)(i)(B)) The buyer of a house-the counterparty to each of Taxpayers' home construction contracts-has no right to use other houses in a development and has no authority to accept them.

Accordingly, IRS will not follow the Ninth Circuit's opinion in Shea Homes. Although IRS disagrees with the Ninth Circuit's decision, it recognizes the precedential effect of the decision to cases appealable in the Ninth Circuit and so will follow it with respect to cases within that circuit, if the opinion cannot be meaningfully distinguished. But, IRS does not acquiesce to the opinion and will continue to litigate its position in cases in other circuits.

Stine LLC vs US AOD 2017-02,04/13/2017.

In an Action on Decision (AOD) announcing its nonacquiescence with a district court decision that two buildings, which the taxpayer had built to function as retail stores, were considered first placed in service for depreciation purposes when they were ready to "house and secure racks, shelving and merchandise." IRS stated that it would continue to assert that a retail store is placed in service for depreciation services when it is actually ready and available for regular operation and income-producing use.

In 2005, Congress enacted the "Gulf Opportunity Zone Act of 2005" (*GO Zone Act,* P.L. 109-135, 12/21/2005), carrying among other provisions tax incentives to encourage rebuilding of the areas ravaged by Hurricane Katrina (as well as Hurricanes Rita and Wilma). One of these incentives allowed qualifying taxpayers to claim 50% bonus first-year depreciation for "GO Zone property." This consisted of qualifying types of property (including nonresidential real property or residential rental property) that met the following requirements:

a. Substantially all of the use of the property was (a) in the GO Zone and (b) in the active conduct of a trade or business by the taxpayer in the GO Zone.

b. The original use of the property in the GO Zone began with the taxpayer after August 27, 2005.

c. The property was acquired by the taxpayer after August 27, 2005 and no written binding contract for the acquisition was in effect before August 28, 2005.

d. The property, generally, was "placed in service" by the taxpayer before January 1, 2008, or before January 1, 2009 in the case of nonresidential real property and residential rental property, but later deadlines apply to certain property used in highly damaged portions of the GO Zone. (§1400N(d)(2), §1400N(d)(6))

Determining the date property is placed in service for depreciation purposes requires ascertaining from the relevant facts and circumstances: (1) the property's specifically assigned function, and (2) when the property is in a condition or state of readiness and availability for the specifically assigned function. (Regulation §1.167(a)-11(e)(1)) The same framework applies to determine the date property is placed in service for purposes of the investment tax credit under §46. (Regulation §1.46-3(d)(1)(ii))

Stine, LLC is a retail operation that, among other things, sells home building material and supplies. It began construction of two new retail stores in 2007. As of December 31, 2008, both stores had been issued certificates of occupancy which allowed them to receive equipment, shelving, racks and merchandise, as well as allowed the appropriate personnel to install and/or stock those items. However, the stores were not yet open for business on December 31, 2008, and the certificates of occupancy did not allow customers to enter the buildings.

The only issue in the case was whether Stine had placed the buildings into service during calendar year 2008.

The district court agreed with Stine that the two buildings were placed in service in 2008, so Stine was entitled to deduct GO Zone additional first-year depreciation under §1400N(d)(1)(A) and §1400N(d)(2)(A)(v). The district court found that the buildings were placed in service when they were "substantially complete meaning in a condition of readiness and availability to perform the function for which [they were] built-in this instance to house and secure racks, shelving and merchandise." In so holding, the court rejected IRS's argument that, because the two buildings were not open for business, they were not placed in service during 2008. (*Stine, LLC,* (DC LA 2015) 115 AFTR 2d 2015-637)

According to IRS, the district court erred first by holding that Stine's intended use for the buildings was to "house and secure racks, shelving and merchandise." The threshold determination in a placed in service analysis is to identify the specifically assigned function of the property in the context of the taxpayer's trade or business (*Sealy Power, Ltd.,* (CA 5 1995) 75 AFTR 2d 95-1213; *Brown,* TC Memo 2013-275), and in this case, Stine intended to use the buildings as retail stores.

Second, the court erred by failing to observe the regulatory requirement that property is placed in service when it is in a condition or state of readiness and availability for its specifically assigned function-i.e., ready and available for regular operation and income-producing use. (Regulation §1.46-3(d)(1)(ii); *Armstrong World Industries, Inc.,* TC memo 1991-326; *Piggly Wiggly Southern, Inc.,* (1985) 84 TC 739) IRS cited a number of Tax Court cases and prior IRS guidance involving electric power plants to illustrate the meaning of "regular operational use for income production," including Revenue Ruling 76-428, 1976-2 CB 47 and Revenue Ruling 76-256, 1976-2 CB 46, which set out five factors to determine whether a plant is ready and available for regular operation.

Thus, IRS will continue to assert that: (1) a retail store is placed in service for depreciation purposes when the building is ready and available to operate as a retail store, the function for which it was built; and (2) the store's ability to begin operations is determined by considering the applicable factors set forth in Revenue Ruling 76-256 and Revenue Ruling 76-248.

Ten Twenty-Six Investors, TC Memo 2017-115.

The Tax Court has upheld IRS's disallowance of a partnership's charitable contribution deduction for a conservation easement because, since the recipient organization did not record it until years later, the easement was unenforceable under State law when transferred. The Court rejected the taxpayer's claim that it actually intended to create a restrictive covenant under common law, finding that the overall facts of the case and terms used in the relevant documentation unambiguously showed that the taxpayer intended to create a conversation easement.

A taxpayer is generally allowed a deduction for any charitable contribution made during the tax year. (§170(a)(1)) §170(f)(3) generally bars a charitable contribution deduction for a contribution of an interest in property that is less than the taxpayer's entire interest in the property, but an exception is made for a qualified conservation contribution, i.e., the contribution, to a qualified organization, of a "qualified real property interest" exclusively for conservation purposes. The interest in property conveyed by an easement must be protected in perpetuity for the contribution of the easement to be a qualified conservation contribution. (§170(h)(2)(C), Regulation §1.170A-14(b)(2))

Under §170(h)(2)(C), a qualified real property interest includes a "perpetual conservation restriction," i.e., a restriction granted in perpetuity on the use which may be made of the real property interest. Regulation §1.170A-14(b)(2) provides that a perpetual conservation restriction is a restriction granted in perpetuity on the use which may be made of real property-including an easement or other interest in real property that, under state law, has attributes similar to an easement (e.g., a restrictive covenant or equitable servitude).

A separate and distinct perpetuity requirement is set out in §170(h)(5), which provides that "[a] contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity." Regulation §1.170A-14(g)(1) further provides that "any interest in the property retained by the donor...must be subject to legally enforceable restrictions...that will prevent uses of the retained interest inconsistent with the conservation purposes of the donation."

In a Federal tax controversy, State law-in this case, New York State-controls the determination of a taxpayer's interest in property, while the tax consequences are determined under Federal law. (*U.S. v. Nat'l Bank of Commerce,* (S Ct 1985) 56 AFTR 2d 85-5210)

Ten Twenty Six Investors (Investors) is a New York State limited partnership that, throughout 2004, owned a 10-story warehouse in New York City (warehouse) that was designed by architect Cass Gilbert and built in 1928.

On December 21, 2004, Investors executed a "Conservation Deed of Easement" (deed) granting a facade easement on the warehouse to National Architectural Trust, Inc. (NAT). A representative of NAT accepted and signed the deed on December 30, 2004, but the deed was not recorded in the Office of the City Register of the City of New York until December 14, 2006.

On its 2004 Form 1065, U.S. Return of Partnership Income, Investors claimed deductions under §170 of $11.4 million for a noncash charitable contribution of the easement (consistent with an appraisal it had obtained) and of $531,975 for a cash charitable contribution to NAT. IRS disallowed both deductions.

Investors challenged IRS's determination in the Tax Court, and IRS moved for partially summary judgment as to the noncash charitable contribution deduction.

IRS contended that the easement in this case was a "conservation easement" under New York State law and, as such, had no legal effect until recorded. Thus, IRS claimed that the warehouse was not subject to legally enforceable restrictions during 2004 as required by Regulation §1.170A-14(g)(1), so Investors was not entitled to a 2004 deduction for its donation.

New York State law defines a conservation easement as:

a. An easement, covenant, restriction or other interest in real property, created under and subject to the provisions of this title which limits or restricts development, management or use of such real property for the purpose of preserving or maintaining the scenic, open, historic, archaeological, architectural, or natural condition, character, significance or amenities of the real property. (*N.Y. Envtl. Conserv. Law* (NYECL) sec. 49-0303(1) *(McKinney* Supp. 2017)

And, under NYECL sec. 49-0305(4), a conservation easement is not effective unless recorded.

Investors, however, argued that the easement at issue was not a "conservation easement" because it was not "created under...the provisions of this title" as described above. Investors pointed to language in NYECL §49-0309 (*McKinney* 2008) which provides:

This title shall not affect any interests or rights in real property which are not conservation easements, and shall not affect the rights of owners to convey any interests in real property which they could now create under existing law without reference to the terms of this title.

Thus, Investors asserted, whether or not the easement was also a conservation easement, NYECL sec. 49-0309 allows owners of property to convey any interest that could have been conveyed before title 49 was enacted. Investors argued that, by delivering the deed of easement to NAT, it created a type of common law interest-a restrictive covenant-which is generally effective in New York upon delivery of a valid deed. (*N.Y. Real Prop. Law* sec. 244 (*McKinney* 2006))

The Tax Court first noted that it, in cases involving substantially identical facts and arguments, it has repeatedly sided with IRS (see, e.g., *Zarlengo,* TC Memo 2014-161, and *Rothman,* TC Memo 2012-163, supplemented by TC Memo 2012-218), as has a district court (*Mecox Partners, LP v. U.S.,* (DC NY 2016) 117 AFTR 2d 2016-593). In each of these cases, a taxpayer delivered a deed to NAT which was not recorded until a later year, and the Court held that, under New York law, the deed was not effective until recorded.

Investors argued that these cases were wrongly decided, and that they misconstrued NYECL title 49 and "failed to consider relevant law" under which the easement would be treated as being protected in perpetuity from the 2004 transfer of the deed. Investors cited *O'Mara v. Town of Wappinger,* (CA 2 2007) 485 F.3d 693, for the proposition that the easement was effective upon delivery. However, the Court found that the O'Mara case did not actually stand for the proposition for which Investors cited it. That case did not involve conservation easements, and while it stated that recording is necessary to be enforceable against subsequent purchasers, this does not otherwise render recording unnecessary for an easement to be effective. And, the Court found that this argument was undermined by the plain language of NYECL sec. 0305(4).

The Court then considered, and rejected, Investors' claim that the deed was not intended to convey a conservation easement because it was not "created under" and did not reference NYECL title 49. The Court found that the deed, which was titled "Conservation Deed of Easement" and which repeatedly used the phrase "conservation easement" throughout, was unambiguous in that it intended to create a conservation easement. The deed's explanation of the purpose of the conveyance also supported this conclusion, as did the precise rights, restrictions, and affirmative responsibilities granted thereunder.

Investors also argued that, even if the deed intended to convey a conservation easement, it was nonetheless enforceable as a common law interest from the time of delivery. The Court, however, looked to New York State law and relevant caselaw and found that conservation easements were separate and distinct from anything created at common law. In addition, the Court rejected Investors' argument that the deed created two different interests-a conservation easement and a restrictive covenant. Notably, the Court found that if every deed intending to create a conservation easement would simultaneously create other common law interests that would be enforceable at common law, the recording requirement would have no meaningful effect.

The Court also found that, even if it had concluded that the deed created a restrictive covenant, it would have failed the perpetuity requirements of §170(h)(2)(C) and §170(h)(5)(A) because it was not recorded in 2004. Investors argued that it was unlikely that the deed would not be enforceable at common law, but the Court found that, even accepting Investors' claim, there were multiple circumstances (e.g., sale of the warehouse to someone without notice of the easement who recorded the conveyance before the easement was recorded) under which enforcement of the restrictions could have been prevented. Accordingly, the requirement in Regulation §1.170A-14(g)(3) that the occurrence of an event that would defeat the transfer be "so remote as to be negligible" standard in Regulation §1.170A-14(g)(3) was not satisfied in this case.

Accordingly, the Tax Court granted IRS's motion for summary judgment and upheld the disallowance of Investors' $11.4 million noncash charitable contribution deduction.

310 Retail, LLC, TC Memo 2017-164.

A deed of easement executed contemporaneously with the gift of a conservation easement satisfied the §170(f)(8)(B) "contemporaneous written acknowledgment" requirement for the taxpayer's charitable contribution deduction.

Under §170, a taxpayer is allowed a charitable contribution deduction for a properly substantiated contribution or gift to or for the use of an organization organized and operated exclusively for charitable or educational purposes. §170(f)(3) generally bars a charitable contribution deduction for a contribution of an interest in property that is less than the taxpayer's entire interest in the property, but an exception is made for a qualified conservation contribution, i.e., the contribution of a qualified real property interest exclusively for "conservation purposes." (§170(h), Regulation §1.170A-14(b)(2))

Under §170(f)(8)(A), no charitable contribution deduction for any contribution of $250 or more is allowed unless the taxpayer substantiates the contribution with a contemporaneous written acknowledgment of the contribution by the donee organization that meets certain specified requirements. Although the acknowledgment is not required to take any particular form, the donee organization must state in the acknowledgment whether it provided any goods or services in consideration, in whole or part, for the contributed property or cash. (§170(f)(8)(B)(ii)) If so, the acknowledgment generally must include a description and good faith estimate of the value of any goods or services provided. (§170(f)(8)(B)(iii)) The doctrine of substantial compliance does not apply to §170(f)(8)(B) 's substantiation requirements.

Certain conservation easement deeds can satisfy §170(f)(8) 's substantiation requirements. For example, in *Simmons*, TC Memo 2009-208, aff'd (CA DC 2011) 107 AFTR 2d 2011-2632, the Court upheld deeds that were signed by representatives of the charity, were contemporaneous with the donation of the easements, and described the properties donated. In *Averyt,* TC Memo 2012-198, the Court similarly upheld the taxpayer's conservation deed, and also held that that deed met §170(f)(8)(B)(ii) because the easement was an unconditional gift, recited no consideration received in exchange for it, and stipulated that it constituted the entire agreement between the parties.

In *RP Golf, LLC,* TC Memo 2012-282, the Tax Court determined that the deed underlying a donor's conservation easement contribution met §170(f)(8) 's substantiation requirements where it sufficiently established that the donee organization did not provide any goods or services in exchange for the easement.

In RP Golf, the taxpayer executed an agreement granting a conservation easement to a not-for-profit corporation, which although it referenced consideration, actually recited no amount. Rather, the agreement described the property's conservation value as its "aesthetic, open space, scenic, recreational, and resource values." The agreement also contained an "entire agreement" clause. Accordingly, the Tax Court found that the agreement, taken as a whole, adequately stated that no goods or services were received in exchange for the contribution.

In *15 West 17th Street LLC,* (2016) 147 TC No. 19, the Tax Court held that the rule of §170(f)(8)(D), which provides a waiver of the requirement that a charitable donor secure and maintain a contemporaneous written acknowledgment from the donee if the donee files a return with that information "on such form and in accordance with such regulations as the Secretary may prescribe," does not currently apply because IRS has not yet issued such regulations. Therefore, a taxpayer cannot rely on §170(f)(8)(D) to meet its contemporaneous written acknowledgment requirement.

On December 30, 2005, 310 Retail, LLC (LLC) executed a preservation deed of easement (deed of easement) granting the Landmarks Preservation Council of Illinois (LPCI) an easement over the facade of its building at 310 South Michigan Avenue in Chicago, which included the Metropolitan Tower (originally known as the Strauss Building). LPCI is an organization described in §501(c)(3) and is a "qualified organization" under §170(h)(3). LPCI caused the deed of easement to be recorded by the Cook County Recorder of Deeds on December 30, 2005.

The deed of easement recited that "the subject matter of this conveyance is a perpetual donation to charity which can no longer be transferred, hypothecated or subjected to liens or encumbrances by Grantor." The granting provision stated as follows:

"NOW, THEREFORE, in consideration of One Dollar ($1.00) and the mutual covenants and terms, conditions, and restrictions hereinafter set forth and other good and valuable consideration, receipt of which is hereby acknowledged,...[LLC] hereby does grant, give, convey, bargain and sell unto...[LPCI], its successors and assigns, irrevocably forever, a Preservation Easement, in perpetuity, in and to the aforesaid Premises, for the purposes of Preserving the Protected Elements and accomplishing the other objectives set forth herein."

However, the deed of easement contained no reference to any goods or services being furnished by LPCI to LLC and recited no receipt by LPCI of any consideration for providing goods or services. In the deed, the parties explicitly stated their understanding that "[t]his instrument, including the exhibits attached hereto, reflects the entire agreement of Grantor and Grantee" and that "[a]ny prior or simultaneous correspondence, understandings, agreements, and representations are null and void upon execution hereof unless set out in this instrument."

On its timely filed 2005 Form 1065 (U.S. Return of Partnership Income), LLC claimed a $26.7 million charitable contribution deduction. LLC attached to its return a Form 8283 (Noncash Charitable Contributions), executed by an appraiser and by LPCI's president. This document contained no statement as to whether LPCI had provided any goods or services to LLC in exchange for LLC's gift.

More than three years after the gift was made, LPCI supplied LLC with a letter stating that "no goods or services have been provided to you in consideration of your prior donation." This letter recited LPCI's belief that it had "acknowledged this donation with a receipt letter" at the time of the gift. But LPCI could not find a copy of such a letter in its files.

In August 2012, almost three years later, LPCI filed an amended Form 990 for its fiscal year ending (FYE) June 30, 2006, which referred to the facade easement and stated that no goods or services had been furnished to the donor in exchange for that gift. The return was unsigned and did not identify LLC as the donor.

In December 2014, LPCI filed a Form 990 for its FYE 2014, which referred to the 2005 facade easement, identified LLC as the donor, and stated that no goods or services had been furnished to LLC in exchange for that gift.

On audit, IRS issued LLC a notice of final partnership administrative adjustment (FPAA), disallowing the claimed charitable contribution deduction in full for failure to satisfy the §170 requirements. Alternatively, the FPAA determined that, if any deduction were allowable, the fair market value of the easement was $1.6 million rather than $26.7 million. The FPAA also determined a 40% "gross valuation misstatement" penalty under §6662(a) and §6662(h) or, in the alternative, a 20% accuracy-related penalty under §6662(a).

Granting LLC partial summary judgment, the Tax Court found the deed of easement satisfied the §170(f)(8)(B) contemporaneous written acknowledgment requirement. The Court also determined (and the taxpayer conceded) that based on 15 W. 17th St.-which was decided after the taxpayer's motion was filed-LLC could not rely on the Forms 990 subsequently filed by the donee organization to relieve the donor of its obligation to have secured a contemporaneous written acknowledgment that met the statutory requirements.

The Court reasoned that the deed of easement in this case was similar in all material respects to the deed in RP Golf, and the Court reached the same conclusion as there. The deed of easement was properly executed by LPCI's president and recorded by the Cook County Recorder of Deeds on December 30, 2005. It thus constituted a "contemporaneous" acknowledgment under §170(f)(8)(C).

This acknowledgment included an affirmative indication that LPCI supplied no goods or services to LLC in exchange for its gift. The deed explicitly stated that it represented the parties' "entire agreement" and that "[a]ny prior or simultaneous correspondence, understandings, agreements, and representations are null and void upon execution hereof unless set out in this instrument." It thus negated the provision or receipt of any consideration not stated therein.

Apart from the charitable conveyance and the covenants attending the easement, the only "consideration" mentioned in the deed of easement was the granting provision's reference to "consideration of One Dollar ($1.00)...and other good and valuable consideration." Neither party contended that LPCI actually furnished LLC with any valuable goods or services in exchange for its gift. Evaluating this clause in the context of the deed overall, the Tax Court concluded that this clause constituted "boilerplate language and has no legal effect for purposes of §170(f)(8)."

The Court determined that, taken as a whole, therefore, the deed of easement included the required affirmative indication that LPCI supplied LLC with no goods or services in exchange for its contribution. Because the deed of easement satisfied this and all other requirements in §170(f)(8)(B), it constituted a contemporaneous written acknowledgment sufficient to substantiate LLC's gift.

Yoklic, TC Memo 2017-143

A taxpayer who received unemployment benefits in Year 1, later in Year 1 received a notice from the state that he actually did not qualify for the benefits, and repaid the benefits in Year 2, had to include the amount of the unemployment benefits in his Year 1 taxable income.

Under the claim of right doctrine, if a taxpayer receives money under a claim of right and without restriction as to its disposition, then he has received income that he is required to report even though it may be claimed that he is not entitled to retain it and may be ordered to restore its equivalent. (*North American Oil Consolidated v. Burnet,* (S Ct 1932) 11 AFTR 16)

The doctrine of rescission represents a minor exception to the claim of right doctrine. IRS has provided that, under the exception, a taxpayer does not have to report as gross income an amount received under a claim of right if the recipient's right to the amount is rescinded and, within the year of receipt, the parties to the payment are restored to the relative positions that they would have otherwise occupied. (Revenue Ruling 80-58, 1980-1 CB 181) Courts, including *Blagaich*, TC Memo 2016-2, have held that income received under a claim of right need not be included in gross income if, in the year of receipt, the taxpayer (1) recognizes an existing and fixed obligation to repay the amount received and (2) makes provisions for repayment.

§85(a) and §85(b) provide for the inclusion of unemployment compensation in gross income, defining the term "unemployment compensation" as "any amount received under a law of the U.S. or of a State which is in the nature of unemployment compensation." In addition, §451(a) provides that, for a cash basis taxpayer, the amount of any item of gross income is included in gross income for the tax year in which received by the taxpayer.

Mr. Yoklic filed a claim for unemployment benefits. The Arizona Department of Economic Security (DES) found Yoklic eligible to receive benefits of $240 per week for each of the weeks ending May 5 to August 4, 2012. Yoklic received $3,360 in unemployment benefits from DES during that period. Later that year, DES issued Yoklic a letter stating that he was not entitled to the unemployment benefits received, resulting in an overpayment of unemployment benefits of $3,360 determined against him. The letter also informed Yoklic that the last date to file a request for review was November 26, 2012.

The only action Yoklic took in response to the letter was to repay the benefits he had received, on September 26, 2013.

DES sent IRS and Yoklic a Form 1099-G, Certain Government Payments, reporting unemployment compensation of $3,360 paid to Yoklic in 2012. Yoklic and his wife prepared their Federal income tax return for 2012, reporting income and expenses on a cash basis. However, they did not report the unemployment compensation on the joint return.

The Court held that Yoklic did not meet the requirements of the rescission doctrine and that therefore the unemployment benefits were taxable in 2012.

The Court found that Yoklic's obligation to repay the unemployment compensation he received from DES in 2012 became fixed in that same year. However, the Yoklics did not contend, nor was there any evidence in the record indicating, that they made provisions for repayment also in that same year. Instead, the record showed repayment to DES the following tax year in September 2013. The doctrine of rescission thus did not save the Yoklics from including in their gross income for 2012 the unemployment benefits.

Preamble to Proposed Regulation 11/25/2016, Proposed Regulation §1.472-8.

Proposed regulations that would amend the inventory price index computation (IPIC) pooling rules to clarify that those rules are applied consistently with the general dollar-value last-in, first-out (LIFO) inventory pooling rule that manufactured or processed goods and resale goods may not be included in the same dollar-value LIFO pool. The proposed regulations are proposed to apply for tax years ending on or after the date the regulations are published as final regulations.

Under §472, a taxpayer can account for inventories using the LIFO accounting method under which inventories on hand at the end of the year are treated as consisting first of inventory on hand at the beginning of the year and then of inventories acquired during the year.

Regulation §1.472-8(a) provides that a taxpayer can elect to determine the cost of its LIFO inventories using the dollar-value method, under which cost is determined by using "base-year" cost expressed in terms of total dollars rather than the quantity and price of specific goods as the unit of measurement. The "base-year" cost is the aggregate of the cost (determined as of the beginning of the tax year for which the LIFO method is first adopted) of all items in a pool. Separate pooling rules apply for taxpayers engaged in the manufacturing or processing of goods (Regulation §1.472-8(b)), and for taxpayers engaged in the wholesaling or retailing of goods purchased from others (Regulation §1.472-8(c)).

Under Regulation §1.472-8(b)(1), a manufacturer or processor must establish one pool for each natural business unit (natural business unit pooling method) unless it elects under Regulation

§1.472-8(b)(3) to establish multiple pools. Further, Regulation §1.472-8(b)(2) provides that where a manufacturer or processor is also engaged in the wholesaling or retailing of goods purchased from others, the wholesaling or retailing operations with respect to such purchased goods will not be considered a part of any manufacturing or processing unit. In addition, Regulation §1.472-8(b)(1) requires that where the manufacturer or processor is also engaged in the wholesaling or retailing of goods purchased from others, any pooling of the LIFO inventory of such purchased goods for wholesaling and retailing operations must be determined in accordance with Regulation §1.472-8(c).

A manufacturer or processor using the natural business unit pooling method can elect to use the multiple pooling method under Regulation §1.472-8(b)(3) for inventory items that are not within a natural business unit. Alternatively, a manufacturer or processor that does not use the natural business unit pooling method can elect to use the multiple pooling method. Under the multiple pooling method, generally each pool should consist of a group of inventory items that are substantially similar. Thus, raw materials that are substantially similar should be pooled together. Similarly, finished goods and goods-in-process should be placed in pools classified by major classes or types of goods.

Under Regulation §1.472-8(c)(1), wholesalers, retailer, jobbers, and distributors must establish inventory pools by major lines, types, or classes of goods. Regulation §1.472-8(c)(1) requires that where a wholesaler or retailer is also engaged in the manufacturing or processing of goods, the pooling of the LIFO inventory for the manufacturing or processing operations must be determined in accordance with Regulation §1.472- 8(b).

In general, any taxpayer that elects to use the dollar-value LIFO method to value LIFO inventories may elect to use the IPIC method to compute the base-year cost and determine the LIFO value of a dollar-value pool for a trade or business, and may also elect to establish dollar-value pools, for those items accounted for using the IPIC method, using the IPIC pooling method provided in Regulation §1.472-8(b)(4) and Regulation §1.472-8(c)(2).

For manufacturers and processors using the IPIC pooling method under Regulation §1.472-8(b)(4), pools may be established for those items accounted for using the IPIC method based on the 2-digit commodity codes (that is, major commodity groups) in Table 9 (formerly Table 6) of the Producer Price Index Detailed Report (PPI Detailed Report), which is published monthly by the United States Bureau of Labor Statistics (BLS). A taxpayer establishing IPIC pools under Regulation §1.472-8(b)(4) may combine IPIC pools that comprise less than 5% of the total inventory value of all dollar-value pools to form a single miscellaneous IPIC pool. If the resulting miscellaneous IPIC pool is less than 5% of the total inventory value of all dollar-value pools, the taxpayer may combine the miscellaneous IPIC pool with its largest IPIC pool.

For retailers using the IPIC pooling method under Regulation §1.472-8(c)(2), pools may be established for those purchased items accounted for using the IPIC method based on either the general expenditure categories (that is, major groups) in Table 3 of the Consumer Price Index Detailed Report (CPI Detailed Report), published monthly by BLS, or the 2-digit commodity codes in Table 9 of the 6 PPI Detailed Report.

For wholesalers, jobbers, or distributors using the IPIC pooling method under Regulation §1.472-8(c)(2), pools may be established for those items accounted for using the IPIC method based on the 2-digit commodity codes in Table 9 of the PPI Detailed Report. A taxpayer establishing IPIC pools under Regulation §1.472-8(c)(2) may combine pools that comprise less than 5% of the total inventory value of all dollar-value pools to form a single miscellaneous IPIC pool. If the resulting miscellaneous IPIC pool is less than 5% of the total inventory value of all dollar-value pools, the taxpayer may combine the miscellaneous IPIC pool with its largest IPIC pool.

The general pooling rules of Regulation §1.472-8(b) and Regulation §1.472-8(c) provide that where a taxpayer is engaged in both a manufacturing or processing activity and a wholesaling or retailing activity, separate pooling rules apply to the separate activities, and goods purchased for resale may not be included in the same pool as manufactured or purchased goods. This general rule is intended to limit cost transference, an inherent problem with pooling. Cost transference may occur, among other circumstances, when inventory items from separate economic activities (for example, manufacturing and resale activities) are placed in the same pool and may cause misallocation of cost or distortion of income. On the other hand, the IPIC pooling rules address circumstances where a trade or business consists entirely of a manufacturing, processing, retailing, or wholesaling activity. IRS has become aware of confusion concerning how the IPIC pooling rules apply where a taxpayer is engaged in both a manufacturing or processing activity and a wholesaling or retailing activity.

The proposed regulations would amend the IPIC pooling rules to clarify that an IPIC-method taxpayer who elects the IPIC pooling method described in Regulation §1.472-8(b)(4) or Regulation §1.472-8(c)(2), and whose trade or business consists of both manufacturing or processing activity and resale activity, may not commingle the manufactured or processed goods and the resale goods within the same IPIC pool. (Proposed Regulation §1.472-8(b)(4), Proposed Regulation §1.472-8(c)(2))

The proposed regulations would provide that a manufacturer or processor using the IPIC pooling method under Regulation §1.472-8(b)(4), that is also engaged, within the same trade or business, in wholesaling or retailing goods purchased from others, may elect to establish dollar-value pools for the manufactured or processed items accounted for using the IPIC method based on the 2-digit commodity codes in Table 9 of the PPI Detailed Report. If the manufacturer or processor makes this election, it would also have to establish pools for its resale goods in accordance with Regulation §1.472- 8(c)(2) (that is, based on the general expenditure categories in Table 3 of the CPI Detailed Report in the case of a retailer or the 2-digit commodity codes in Table 9 of the PPI Detailed Report in the case of a retailer, wholesaler, jobber, or distributor).

If the manufacturer or processor chooses to use the 5% method of pooling, manufactured or processed IPIC pools (IPIC pools consisting of manufactured or processed goods) of less than 5% of the total current year cost of all dollar-value pools would be able to be combined to form a single miscellaneous IPIC pool of manufactured or processed goods. The manufacturer or processor could also combine resale IPIC pools (IPIC pools consisting of resale goods) of less than 5% of the total value of inventory to form a single miscellaneous IPIC pool of resale goods. If the miscellaneous IPIC pool of manufactured or processed goods is less than 5% of the total value of inventory, the manufacturer or processor would be able to combine the miscellaneous IPIC pool of manufactured or processed goods with its largest manufactured or processed IPIC pool. The miscellaneous IPIC pool of resale goods could not be combined with any other IPIC pool. (Proposed Regulation §1.472-8(b)(4))

Under the proposed regulations, a wholesaler, retailer, jobber, or distributor using the IPIC pooling method under Regulation §1.472-8(c)(2), that is also engaged, within the same trade or business, in manufacturing or processing activities, would be able to elect to establish dollar-value pools for the resale goods accounted for using the IPIC method in accordance with Regulation §1.472-8(c)(2) (that is, based on the general expenditure categories in Table 3 of the CPI Detailed Report in the case of retailer or the 2-digit commodity codes in Table 9 of the PPI Detailed Report in the case of a wholesaler, retailer, jobber, or distributor).

If the wholesaler, retailer, jobber, or distributor makes this election, it would also have to establish pools for its manufactured or processed goods based on the 2-digit commodity codes in Table 9 of the PPI Detailed Report. If the wholesaler, retailer, jobber, or distributor chooses to use the 5% method of pooling, resale IPIC pools of less than 5% of the total value of inventory would be able to be combined to form a single miscellaneous IPIC pool of resale goods. The wholesaler, retailer, jobber, or distributor would also be able to combine the IPIC pools of manufactured or processed goods of less than 5% of the total value of inventory to form a single miscellaneous IPIC pool of manufactured or processed goods. If the resale miscellaneous IPIC pool is less than 5% of the total value of inventory, the wholesaler, retailer, jobber, or distributor could combine the resale miscellaneous IPIC pool with the largest resale IPIC pool. The miscellaneous IPIC pool of manufactured or processed goods would not be able to be combined with any other IPIC pool. (Proposed Regulation §1.472-8(c)(2))

Each of the 5% rules is an of accounting method change, and a taxpayer would not be able to change to, or cease using, either 5% rule-or make a change in pooling required or permitted as a result of a 5% rule-without obtaining IRS's prior consent. (Proposed Regulation §1.472-8(b)(4), Proposed Regulation §1.472-8(c)(2))

The proposed regulations would also modify Regulation §1.472-8(b), Regulation §1.472-8(c), and Regulation §1.472-8(e)(3) to update references from Table 6 (Producer price indexes and percentage changes for commodity groupings and individual items, not seasonally adjusted) to Table 9 (Producer price indexes and percentage changes for commodity and service groupings and individual items, not seasonally adjusted) because of BLS changes in the PPI Detailed Report. The regulations would also modify Regulation §1.472-8(e)(3)(ii) to remove the exception to the trade or business requirement for taxpayers using the Department Store Inventory Price Indexes because BLS discontinued publishing these indexes after December 2013.

Revenue Procedure 2017-33, 2017-19 IRB.

Revenue Procedure that provides guidance with respect to the Protecting Americans for Tax Hikes Act of 2015 (PATH Act)'s amendments to (i) expensing §179 property, (ii) additional first-year (bonus) depreciation deduction under §168(k), and (iii) the qualified Indian reservation property depreciation provision under §168(j).

§179(a) allows a taxpayer to elect to treat the cost (or a portion of the cost) of any §179 property as an expense for the tax year in which the taxpayer places the property in service. §179(b)(1) and §179(b)(2) prescribe a dollar limitation on the aggregate cost of §179 property that can be treated as an expense under §179(a). The dollar limitation is the amount under §179(b)(1) (the §179(b)(1) limitation), reduced (but not below zero) by the amount by which the cost of §179 property placed in service during the tax year exceeds the amount under §179(b)(2) (the §179(b)(2) limitation).

§179(b)(3)(A) provides that a taxpayer's §179 deduction for any tax year, after application of the §179(b)(1) and §179(b)(2) limitations, is limited to the taxpayer's taxable income for that tax year that is derived from the taxpayer's active conduct of any trade or business during that tax year (taxable income limitation). §179(b)(3)(B) provides that the amount of any cost of §179 property elected to be expensed in a tax year that is disallowed as a §179 deduction under the taxable income limitation may be carried forward for an unlimited number of years.

If a taxpayer elects to apply §179(f), §179(f)(1) provides that §179 property includes qualified real property. §124(c)(1) of the PATH Act extended the application of this rule to 2015, created a qualified real property limit of $250,000 for 2015, and provided that the above-described carryover did not apply to qualified real property placed in service before 2016.

Section 124(c)(2) of the PATH Act further amended §179(f) by making permanent the treatment of qualified real property as §179 property if the taxpayer elects to apply §179(f). Section 124(c)(2) of the PATH Act also amended §179(f) by striking out the $250,000 rule and the no-carryover rule.

Prior to amendment by §124(d) of the PATH Act, §179(c)(2) provided that a §179 election for tax years beginning after 2002 and before 2015 may be revoked by the taxpayer with respect to any §179 property. Revenue Procedure 2008-54, 2008-2 CB 722, §7, provides that for a tax year beginning after 2007 and before the last year provided in §179(c)(2) for revoking a §179 election, the taxpayer will be permitted to make a §179 election on an amended return for that tax year without IRS's consent.

Section 124(d) of the PATH Act amended §179(c)(2) to make permanent the permission granted to a taxpayer to revoke a §179 election for any §179 property without IRS's consent.

Section 124(e) of the PATH Act amended §179(d)(1) to allow air conditioning and heating units to be §179 property. This amendment applies to tax years beginning after 2015.

Prior to amendment by the PATH Act, §168(k)(1) allowed a 50% additional first-year depreciation deduction for qualified property that, as provided by §168(k)(2)(A), was acquired by a taxpayer after 2007 and placed in service by the taxpayer before 2015 (before 2016 in the case of property described in §168(k)(2)(B) or §168(k)(2)(C)).

The PATH Act amended §168(k)(2) by extending the placed-in-service date to before 2020 (before 2021 in the case of property described in §168(k)(2)(B) or §168(k)(2)(C)), and by modifying the definition of qualified property. As amended by §143(b)(1) of the PATH Act, qualified property under §168(k)(2)(A) includes property that is qualified improvement property instead of qualified leasehold improvement property.

The PATH Act also provides that the additional first-year depreciation deduction percentage of 50% is phased down beginning for qualified property placed in service after December 31, 2017 (after December 31, 2018, for property described in §168(k)(2)(B) or §168(k)(2)(C)).

Section 143(b)(6)(D) of the PATH Act adds §168(k)(7) to the Code. It allows a taxpayer to elect not to deduct additional first-year depreciation for any class of property placed in service by the taxpayer in the tax year.

§168(j) provides that for purposes of §168(a), the applicable recovery period for qualified Indian reservation property is determined in accordance with the table contained in §168(j)(2) instead of the table contained in §168(c).

§168(j)(8), added by the PATH Act, allows a taxpayer to elect not to apply §168(j) for all property that is in the same class of property and placed in service in the same tax year (the §168(j)(8) election).

The Revenue Procedure includes the following explanations of PATH Act §179 changes.

a. Qualified real property. For any tax year beginning after December 31, 2015, the §179(b)(1) limitation amount and the §179(b)(2) limitation amount, and the §179(b)(3)(B) carryover rules apply to qualified real property placed in service by the taxpayer during that tax year, if the taxpayer elects to apply §179(f). (Revenue Procedure 2017-33, §3.01)

b. Making §179 elections by amended returns. Noting that there has been taxpayer confusion concerning making a 179 election for tax years that begin after 2014, the Revenue Procedure provides that, for any tax year that begins after 2014, a taxpayer may make a §179 election with respect to any §179 property without IRS's consent on an amended Federal tax return for the tax year in which the taxpayer places in service the §179 property. (Revenue Procedure 2017-33, §3.02)

c. Air conditioning and heating units qualifying as §179 property. As long as the air conditioning or heating unit is not a component of a larger unit of property, an air conditioning or heating unit qualifies as §179 property if such unit is §1245 property, depreciated under §168, acquired by purchase for use in the active conduct of the taxpayer's trade or business, and placed in service by the taxpayer in a tax year beginning after 2015. For example, portable air conditioners, such as window air conditioning units, and portable heaters, such as portable plug-in unit heaters, that are placed in service by the taxpayer in a tax year beginning after 2015 may qualify as §179 property.

An example of an air conditioning or heating unit that will not qualify as §179 property is any component of a central air conditioning or heating system of a building, including motors, compressors, pipes, and ducts, whether the component is in, on, or adjacent to a building.

If a component of a central air conditioning or heating system of a building meets the definition of qualified real property, as defined in §179(f)(2), and the component is placed in service by the taxpayer in a tax year beginning after 2015, the component may qualify as §179 property if the taxpayer elects to apply §179(f). (Revenue Procedure 2017-33, §3.03)

The Revenue Procedure includes the following explanations of PATH Act §168(k) changes:

a. **Qualified property**. The rules for determining whether depreciable property is eligible for additional first-year depreciation deduction under §168(k) are similar to the rules in §168(k) as in effect before the enactment of the PATH Act. However, qualified property under §168(k)(2)(A) includes property that is qualified improvement property instead of qualified leasehold improvement property. Further, the acquisition date requirement in pre-PATH Act §168(k)(2)(A)(iii) and the related party rules in pre-PATH Act 168(k)(2)(E)(iv) do not apply. However, a new acquisition date requirement applies for property described in §168(k)(2)(B) or §168(k)(2)(C). (Revenue Procedure 2017-33, §4.01(1))

For example, to determine if the acquisition date requirement is met, rules similar to the rules in Regulation §1.168(k)-1(b)(4) for "qualified property" or for "30 percent additional first year depreciation deduction" apply. However, in applying Regulation §1.168(k)-1(b)(4), Regulation §1.168(k)-1(b)(4)(ii) (A)-(D) and Regulation §1.168(k)-1(b)(4)(iv) do not apply. (Revenue Procedure 2017-33, §4.01(2)(a))

b. **Phase down of 50% rate.** The Revenue Procedure sets out rules for the phaseout. For example, for qualified property described in §168(k)(2)(B) and placed in service in 2019 but acquired, or acquired pursuant to a written contract entered into, before 2019, the 40% rate applies only to the property's unadjusted depreciable basis attributable to the property's manufacture, construction, or production before January 1, 2019. For qualified property described in §168(k)(2)(B), placed in service in 2019, and acquired, or acquired pursuant to a written contract entered into, in 2019, the 30% rate applies only to the property's unadjusted depreciable basis attributable to the property's manufacture, construction, or production before January 1, 2020. For qualified property described in §168(k)(2)(C) and placed in service in 2019, the 30% and 40% apply to the property's unadjusted depreciable basis. (Revenue Procedure 2017-33, §4.03)

c. **Election not to deduct additional first-year depreciation.** The rules for making the election under §168(k)(7) not to deduct additional first-year depreciation (the §168(k)(7) election) are similar to the rules for making such election under §168(k)(2)(D)(iii) as in effect before the enactment of the PATH Act. As a result, the §168(k)(7) election applies to all qualified property that is in the same class of property and placed in service in a tax year. If the §168(k)(7) election is made for a class of property that is qualified property placed in service during the tax year, no additional first-year depreciation deduction is allowable for that property and §168(k)(2)(F) (coordination with passenger auto depreciation cap) does not apply to that property.

However, that property is still qualified property for purposes of §168(k), assuming all the requirements of §168(k)(2) are met. For example, if a calendar-year taxpayer makes the §168(k)(7) election for a class of property that is qualified property placed in service during 2016, the depreciation adjustments under §56 and the regulations under §56 do not apply to the property to which the election applies for purposes of computing the taxpayer's alternative minimum taxable income. (Revenue Procedure 2017-33, §4.04(1))

The Revenue Procedure also contains rules for how the election not to deduct additional first-year depreciation applies to a taxpayer with a tax year beginning in 2015 and ending in 2016. (Revenue Procedure 2017-33, §4.04(3))

The §168(j)(8) election applies to all qualified Indian reservation property, as defined in §168(j)(4), that is in the same class of property and placed in service in the same tax year. If the §168(j)(8) election is made for a class of property that is qualified Indian reservation property placed in service during the tax year, the applicable recovery period for that property for purposes of §168(a) is determined in accordance with the table contained in §168(c), and the depreciation adjustments under §56 and the regulations under §56 apply to that property for purposes of computing the taxpayer's alternative minimum taxable income. Once made, the §168(j)(8) election is irrevocable.

The term "class of property" means each class of property described in the table contained in §168(j)(2) (for example, 3-year property). (Revenue Procedure 2017-33, §4.05)

Revenue Procedure 2008-54, 2008-2 CB 722, §7, is obsoleted for tax years beginning after 2014. (Revenue Procedure 2017-33, §6)

The Revenue Procedure is effective April 20, 2017. (Revenue Procedure 2017-33, §7)

Revenue Procedure 2017-30, 2017-18 IRB 11131

Updated list of accounting method changes to which IRS's automatic change procedures apply.

Under §446(e), taxpayers must obtain IRS's consent before changing a method of accounting for federal income tax purposes. In most cases, a taxpayer that wishes to change its method of accounting must apply and secure the prior consent of IRS. For some accounting method changes, IRS provides an automatic procedure for obtaining its consent to the change. Automatic consent procedures are only available for certain kinds of changes. In general, a taxpayer uses Form 3115 (Application for Change in Accounting Method) for an accounting method change.

In January, 2015, IRS issued Revenue Procedure 2015-13, 2015-5 IRB 419, which updated and revised the procedures under which a taxpayer may obtain automatic consent for a change in an accounting method, and Revenue Procedure 2015-14, 2015-5, which contained a list of automatic changes to which the automatic change procedures apply. Both of those revenue procedures were updated thereafter.

Revenue Procedure 2017-30 contains an updated list of accounting method changes to which IRS automatic procedures apply.

Revenue Procedure 2017-30 sets out several of the updates that it contains as "significant changes." Many of these changes are modifications to reflect material that has become obsolete. Other significant changes include:

a. The procedures relating to partial dispositions of tangible depreciable assets to which an IRS adjustment pertains are modified to provide that they do not apply to any partial disposition election specified in Regulation §1.168(i)-8(d)(2)(i) that is not made pursuant to Regulation §1.168(i)-8(d)(2)(iii);

b. The procedures relating to start-up expenditures are modified to include a change in the amortization period of a start-up expenditure to 180 months;

c. The procedures relating to changes for tangible property are modified to provide that they do not apply to amounts paid or incurred for repair and maintenance costs that the taxpayer is changing from capitalizing to deducting and for which the taxpayer has received a payment for specified energy property in lieu of tax credits;

d. The procedures relating to capitalizing interest with respect to the production of designated property under Regulation §1.263A-8 through Regulation §1.263A-14 are modified to include changes from an improper method of capitalizing interest under regulations to capitalizing interest in accordance with those regulations. These procedures are also modified to require the statement attached to the Form 3115 to include details regarding the taxpayer's sub-methods of accounting for determining capitalizable interest in accordance with Regulation §1.263A-8 through Regulation §1.263A-14.

e. The procedures relating to impermissible methods of identification and valuation of inventory are modified to clarify that: (i) a taxpayer can make a change under those procedures if the taxpayer is changing from an impermissible method of identifying or valuing inventories under §471, and/or an impermissible method described in Regulation §1.471-2(f)(1) through Regulation §1.471-2(f)(5); (ii) a taxpayer cannot make a change under those procedures to allocate costs to inventory under §471 or §263; and (iii) a taxpayer cannot make a change under those procedures if the taxpayer is "currently deducting inventories."

f. The procedures relating to permissible methods of identification and valuation of inventory are modified to clarify that a taxpayer cannot make a change under those procedures to allocate costs to inventory under §471 or §263A.

g. The procedures relating to a taxpayer changing its method of accounting from the mark-to-market method of accounting described in §475 to a realization method of accounting are modified to clarify that a change under those procedures is not limited to a change required by §475.

h. The procedures relating to the revocation of the §1278(b) election (i.e., to currently include in income market discount on bonds) are modified to provide that, for purposes of those procedures, a taxpayer also is treated as having made a deemed §1278(b) election for a tax year if, for one or more market discount bonds that were acquired by the taxpayer during that tax year, the taxpayer includes in gross income on the tax returns for that tax year and for the following tax year the market discount attributable to each tax year, other than where the taxpayer includes the discount as a result of a disposition of the bond or a partial principal payment on the bond.

Except as otherwise provided, Revenue Procedure 2017-30 is effective for a Form 3115 filed on or after April 19, 2017, for a year of change ending on or after August 31, 2016, that is filed under the automatic change procedures of Revenue Procedure 2015-13, as modified.

If, before April 19, 2017, a taxpayer properly filed a Form 3115 under the non-automatic change procedures in Revenue Procedure 2015-13 requesting IRS's consent for a change in method of accounting described in Revenue Procedure 2016-29, and the Form 3115 is pending with IRS's national office on April 19, 2017, the taxpayer may choose to make the change in method of accounting under the automatic change procedures in Revenue Procedure 2015-13 if the taxpayer is otherwise eligible to use Revenue Procedure 2017-30 and the automatic change procedures in Revenue Procedure 2015-13.

Revenue Procedure 2017-29, 2017-14 IRB.

Inflation-adjusted §280F depreciation limits for business autos, light trucks and vans (including minivans) placed in service by the taxpayer in 2017, as well as the annual income inclusion amounts for such vehicles first leased in 2017.

There are four sets of dollar limits for vehicles placed in service by the taxpayer in 2017. Two are for passenger autos that are not trucks or vans and are subject to the luxury-auto limits of §280F (they are rated at 6,000 pounds unloaded gross vehicle weight or less). One set of limits applies to autos for which the bonus depreciation rules do not apply under §168(k) (the auto is pre-owned or not used more than 50% for business, the taxpayer elects out of §168(k) or elects to increase its §53 alternative minimum tax (AMT) credit limit instead of claiming bonus first year depreciation); the other set of limits applies to autos for which the bonus depreciation rules do apply.

There also are two sets of limits for light trucks or vans (passenger autos built on a truck chassis, including minivans and sport-utility vehicles (SUVs) built on a truck chassis) that are subject to the luxury-auto limits (they are rated at 6,000 pounds gross (loaded) vehicle weight or less). (§280F(d)(5)(A)) One set of limits applies to light trucks and vans for which the bonus depreciation rules do not apply under §168(k); the other set of limits applies to light trucks and vans for which the bonus depreciation rules do apply. Certain non-personal-use vehicles are exempt from the luxury auto limits regardless of their weight.

The following are the annual depreciation dollar caps for vehicles that are subject to the luxury-auto limits of §280F and are placed in service by the taxpayer in calendar year 2017.

If the bonus first year depreciation rules do not apply to an auto (not a truck or van):

a. $3,160 for the placed in service year;
b. $5,100 for the second tax year;
c. $3,050 for the third tax year; and
d. $1,875 for each succeeding year.

If the bonus depreciation rules do apply to an auto (not a truck or van):

a. $11,160 for the placed in service year;
b. $5,100 for the second tax year;
c. $3,050 for the third tax year; and

d. $1,875 for each succeeding year.

Observation: For autos first placed in service in 2017, the dollar figures for all tax years are the same as those that applied for autos placed in service in 2016.

If the bonus depreciation rules do not apply to a light truck or van (passenger auto built on a truck chassis, including minivan and sport-utility vehicle (SUV) built on a truck chassis):

a. $3,560 for the placed in service year;
b. $5,700 for the second tax year;
c. $3,450 for the third tax year; and
d. $2,075 for each succeeding year.

If the bonus depreciation rules do apply to a light truck or van:

a. $11,560 for the placed in service year;
b. $5,700 for the second tax year;
c. $3,450 for the third tax year; and
d. $2,075 for each succeeding year.

Observation: For a light truck or van placed in service in 2017, the dollar figures are the same as for such vehicles first placed in service in 2016, except that the third year amount is $100 higher.

Observation: The dollar limits must be reduced proportionately if business/investment use of a vehicle is less than 100%.

Observation: Heavy SUVs-those that are built on a truck chassis and are rated at more than 6,000 pounds gross (loaded) vehicle weight-are exempt from the luxury-auto dollar caps because they fall outside of the §280F(d)(5) definition of a passenger auto.

A taxpayer that leases a business auto may deduct the part of the lease payment representing business/investment use. If business/investment use is 100%, the full lease cost is deductible. So that lessees cannot avoid the effect of the luxury auto limits, however, they must include a certain amount in income during each year of the lease to partially offset the lease deduction, if the vehicle's fair market value exceeds certain dollar limits. (§280F(c)) The income inclusion amount varies with the initial fair market value of the leased auto and the year of the lease, and is adjusted for inflation each year.

Tables 5 and 6 of Revenue Procedure 2017-29 carry the income inclusion tables for passenger autos with a lease term beginning in 2017 and a fair market value over $19,000, and light trucks and vans with a lease term beginning in 2017 with a fair market value over $19,500.

Revenue Procedure 2017-22, 2017-6 IRB.

The safe harbor provided in Revenue Procedure 2010-46, 2010-49 IRB 814, applies to any Transportation Investment Generating Economic Recovery grants (TIGER Discretionary Grants) for capital investments in surface transportation infrastructure made by the Department of

Transportation (DOT) pursuant to legislative authorizations of these grants made after the publication of that Revenue Procedure in 2010.

Under §118(a), a corporation's gross income does not include a contribution to its capital. Regulation §1.118-1 provides that §118 applies to contributions to a corporation's capital made by a person other than a shareholder. For example, property contributed to a corporation by a governmental unit for the purpose of enabling the corporation to expand its operating facilities will qualify. When a corporation receives money from a nonshareholder as a contribution to its capital, §362(c)(2) requires a basis reduction in the corporation's property.

In November of 2010, IRS issued Revenue Procedure 2010-46, which, in part, provides a safe harbor under §118(a) for certain grant amounts received by corporate taxpayers engaged in a transportation trade or business for capital investments in surface transportation infrastructure under (1) the Supplemental Discretionary Grants for Capital Investments in Surface Transportation Infrastructure (TIGER I Discretionary Grants) program as authorized by Title XII, Division A of the American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5); or (2) the National Infrastructure Investments (TIGER II Discretionary Grants) program as authorized by the Transportation, Housing and Urban Development, and Related Agencies Appropriations Act for 2010 (Title I, Division A of the Consolidated Appropriations Act, 2010 (P.L. 111-117)).

In 2009, the Office of the Secretary of Transportation issued a Notice of Funding Availability (NOFA) (74 FR 28755), that provides guidance on TIGER I Discretionary Grants. The grants must be for capital investments in surface transportation infrastructure. In 2010, the Office of the Secretary of Transportation issued a NOFA (75 FR 30460) that provides guidance on TIGER II Discretionary Grants. The grants must be for capital investments in surface transportation infrastructure. The 2010 NOFA contemplates that some funds may be used to fund the planning, preparation, or design of projects (TIGER II Planning Grants). DOT has issued additional NOFAs and Notices of Funding Opportunity (NOFOs) as legislation enacted subsequent to the publication of Revenue Procedure 2010-46 has provided further appropriations for TIGER Discretionary Grants awarded by DOT.

Revenue Procedure 2017-22 clarifies that the safe harbor of Revenue Procedure 2010-46 applies to corporate taxpayers engaged in a transportation trade or business that receive grant amounts for the costs of capital investments in surface transportation infrastructure under any TIGER Discretionary Grants, including those authorized in each year following those described in Revenue Procedure 2010-46, as well as any to be authorized in the future. In no case will Revenue Procedure 2017-22 apply to amounts received to pay the subsidy and administrative costs of the Transportation Infrastructure Finance and Innovation Act of 1998 or to amounts received for any TIGER planning grants. Further, Revenue Procedure 2017-22 does not apply to noncorporate taxpayers. (Revenue Procedure 2017-22, §3)

In Revenue Procedure 2017-22, §4, IRS states that it will not challenge a corporate taxpayer's treatment of grant amounts received by the corporation under any TIGER Discretionary Grants for capital investments in surface transportation infrastructure as a nonshareholder contribution to the capital of the corporation under §118(a) if the corporation properly reduces the basis of its property under §362(c)(2) and its regulations. For purposes of Revenue Procedure 2017-22, TIGER Discretionary Grants include those TIGER Discretionary Grants authorized in each year following those described in Revenue Procedure 2010-46, as well as any to be authorized in the future.

Chief Counsel Advice 201724026.

A taxpayer's gross receipts derived from online services providing the infrastructure for an unspecified global online service were not eligible for the domestic production activities deduction under §199. None of its gross receipts were derived from providing customers access to computer software that was manufactured, produced, grown or extracted (MPGE) by the taxpayer in whole or in significant part within the U.S. for the customers' direct use while connected to online software under Regulation §1.199-3(i)(6)(iii).

Under §199, taxpayers may claim a deduction to offset income from domestic manufacturing and other domestic production activities. In general, the deduction equals 9% of the smaller of the taxpayer's: (a) qualified production activities income (QPAI) for the tax year, or (b) taxable income (modified adjusted gross income, for individual taxpayers), without regard to the §199 deduction, for the tax year. The §199 deduction cannot exceed 50% of the W-2 wages of the employer, attributable to domestic production, for the tax year.

QPAI for any tax year is equal to the excess, if any, of the taxpayer's domestic production gross receipts (DPGR) from specified activities over the sum of the cost of goods sold (CGS) allocable to DPGR and other expenses, losses, or deductions (other than the deduction allowed by §199) that are properly allocable to such receipts.

Under §199(c)(4)(a)(i)(I), DPGR is the gross receipts of a taxpayer which are derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property (QPP) which was MPGE by the taxpayer in whole or in significant part within the U.S. QPP includes computer software. (§199(c)(5))

The term "derived from the disposition" of QPP is limited to the gross receipts directly derived from the disposition. Applicable Federal income tax principles apply to determine whether a transaction is, in substance, a disposition, or whether it is a service (which does not give rise to the §199 deduction), or whether it is some combination thereof. (Regulation §1.199-3(i)(1)(i))

DPGR includes gross receipts derived from any lease, rental, license, sale, exchange or other disposition of computer software manufactured or produced by the taxpayer in whole or in significant part within the U.S. (Regulation §1.199-3(i)(6)(i))

In general, under Regulation §1.199-3(i)(6)(ii), gross receipts derived from customer and technical support, telephone and other telecommunication services, online services (such as Internet access services, online banking services, providing access to online electronic books, newspapers, and journals), and other similar services do not constitute gross receipts derived from a disposition of computer software. However, Regulation §1.199-3(i)(6)(iii) provides an exception. "Notwithstanding" Regulation §1.199-3(i)(6)(ii), if a taxpayer derives gross receipts from providing customers access to computer software produced in whole or significant part by the taxpayer within the U.S. for the customers' direct use while connected to the Internet or any other public or private communications network (online software), then such gross receipts will be treated as derived from the disposition of computer software only if either:

1. The taxpayer derives, on a regular basis, gross receipts from the lease, rental, license, sale, etc., to unrelated persons of computer software that has only minor or immaterial differences from the online software, and has been provided to customers on a tangible medium (e.g., a disk or DVD) or by electronic download from the internet. This is known as the Self-Comparable Exception. (Regulation §1.199-3(i)(6)(iii)(A)) or

2. An unrelated person derives, on a regular basis, gross receipts from the lease, rental, license, sale, etc., of software that is substantially identical to the taxpayer's online software, and delivers that software on a tangible medium or by electronic download from the Internet. This is known as the Third-Party Comparable Exception. (Regulation §1.199-3(i)(6)(iii)(B))

Regulation §1.199-3(i)(6)(v) provides a number of examples. The first three involve, respectively, a bank providing computer software to enable its customers to receive online banking services for a fee, an internet auction company that produces software to enable customers to participate in internet auctions for a fee, and a company that produces computer software to run its telephone, voicemail, and e-mail services. In all three examples, gross receipts are determined to be derived from services and not from the disposition of computer software, and the gross receipts are not DPGR.

The fourth and fifth examples involve tax preparation software for customers' direct use over the Internet, where gross receipts are treated as DPGR.

The CCA is redacted to the point where a clear picture of Taxpayer's business cannot be determined. Overall, what emerges is that Taxpayer provides the infrastructure to enable a global online activity (perhaps something like online gaming or gambling) on a variety of platforms. Taxpayer's infrastructure enabling the operation of various platforms includes websites, user interfacing software applications, non-user interface software applications, servers where computer software is hosted (data centers), other hardware, and the computer network.

Taxpayer charges a variety of fees for the features and functions offered to customers on each platform. It does not separately or directly charge for computer software on the platforms or the enabling infrastructure. Depending on the platform, some features are offered for free.

Taxpayer asserted that the use of the term "notwithstanding" introducing the Self-Comparable and Third-Party Comparable Exceptions in Regulation §1.199-3(i)(6)(iii), converted all gross receipts from providing online services as described in Regulation §1.199-3(i)(6)(ii), to gross receipts from a disposition of computer software if all of the elements described in Regulation §1.199-3(i)(6)(iii)(A), or Regulation §1.199-3(i)(6)(iii)(B) are met.

Taxpayer claimed the Third-Party Comparable Exception in Regulation §1.199-3(i)(6)(iii)(B) applied, even though it could find no other person providing software substantially identical to what it provided. Rather, it identified discrete features and functions on software it provided that corresponded to discrete functions offered by third-party computer software companies. On a function-by-function basis, Taxpayer identified about two dozen different computer software programs offered for disposition to customers by third parties, which Taxpayer claimed as satisfying all of the requirements of the Third-Party Comparable Exception.

The CCA concludes that none of Taxpayer's gross receipts are eligible for the domestic production activities deduction under §199.

The CCA points out that the phrase "notwithstanding [Regulation §1.199-3(i)(6)(ii)]" introduces the exception, but the gross receipts excepted from Regulation §1.199-3(i)(6)(ii) are limited to those described by the clause that follows that phrase, namely: if a taxpayer derives gross receipts from providing customers access to computer software MPGE in whole or in significant part by the taxpayer within the U. S. for the customers' direct use while connected to the Internet or any other public or private communications network....

According to the CCA, the clause in Regulation §1.199-3(i)(6)(iii) limits which gross receipts can meet the exceptions to be treated as from a disposition and requires Taxpayer to establish the necessary link between the customer's payment to Taxpayer (i.e. Taxpayer's gross receipts), and Taxpayer's online software that customers access and directly use.

Observation: This is not the first time this issue has come up. Chief Counsel Advice 201603028 (where all the facts are redacted), also deals with a taxpayer that appeared to take a position that the Self-Comparable and Third-Party Comparable Exceptions override exclusion of online services income. There, IRS determined that there was no objective evidence for the taxpayer's position.

In the new CCA, IRS points out that the regulations illustrate that there are cases in which a taxpayer allows customers access to a taxpayer's online software, but does not derive gross receipts from that access because the online software is only enabling the provision of services. The first two examples in Regulation §1.199-3(i)(6)(v), where gross receipts were held to be derived from services and not from the disposition of computer software, were analogous to Taxpayer's situation. It did not charge fees for customers' direct use of computer software but, rather, provided access to the computer software needed for its customers to participate in the online activity, and not for the direct use of computer software. Gross receipts were not derived from providing customers access to computer software for the customers' direct use.

The CCA says the fourth and fifth examples in Regulation §1.199-3(i)(6)(v) also support its interpretation of the Regulation. The gross receipts derived in these examples are distinguishable from Taxpayer's gross receipts because the online tax preparation computer software is not enabling the taxpayer to provide a service to its customers. Customers are paying for the computer software to complete their tax return. If, in the examples, customers were only using the online software to enter Form W-2 information, which a tax-return preparer was using to complete the customers' tax returns, then the computer software would only be enabling the provision of a service by the tax-return preparer.

In sum, the CCA concludes that Taxpayer's gross receipts and fees in connection with the unspecified online activity are for services enabled in part by computer software, rather than from providing customers access to computer software for their direct use. Taxpayer cannot treat any of these receipts and fees as from the disposition of computer software under Regulation §1.199-3(i)(6)(iii). They remain gross receipts derived from online services under Regulation §1.199-3(i)(6)(ii), and therefore are ineligible for the §199 deduction.

Observation: The CCA does not deal with the issue of whether the Third-Party Comparable Exception in Regulation §1.199-3(i)(6)(iii)(B) may be applied on a function-by-function basis.

Chief Counsel Advice 201718011.

A taxpayer's expenses to develop a process plant to extract coal were not eligible for the §174(a) deduction for research and experimental (R&E expenses) or for the §41 research credit. The heavily redacted CCA reaches those conclusions because the expenses are exploration expenses under §174(d). However, the expenses are deductible as mining exploration expenses under §617 if the taxpayer so elects.

Under §174(a), a taxpayer may treat R&E expenses paid or incurred by the taxpayer during the tax year in connection with its trade or business as a deduction rather than chargeable to a capital account.

R&E expenses are expenses incurred in connection with the taxpayer's trade or business which represent R&E costs in the experimental or laboratory sense, i.e., they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Whether expenses qualify as R&E expenses depends on the nature of the activity to which the expenses relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. (Regulation §1.174-2(a)(1))

The term "product" includes any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license. (Regulation §1.174-2(a)(2))

The provisions of Regulation §1.174-2(a)(2) apply not only to costs paid or incurred by the taxpayer for R&E undertaken directly by the taxpayer but also to expenses paid or incurred for R&E carried on in its behalf by another person or organization. (Regulation §1.174-2(a)(8))

§174(a) does not apply to "any expenditure paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral" (including oil and gas). (§174(d), Regulation §1.174-2(c))

A taxpayer who pays or incurs costs of exploring for minerals other than oil and gas may elect under §617, to deduct them in the year paid or incurred. §617 does not apply with respect to amounts paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of oil or gas or of any mineral with respect to which a deduction for percentage depletion is not allowable under §613(a) (percentage depletion rules).

§41 allows taxpayers a credit against taxes for increasing research activities. To be qualified research, the research must satisfy four requirements, one of which is that the expenses connected with the research must be eligible for treatment as R&E expenses under §174. (§41(d)(1)(A)) Under §280C(c)(1), to the extent a taxpayer is allowed a §41 research credit, research expenses cannot be deducted under §174.

In the years at issue, Taxpayer began looking into the potential development of a Process plant to extract coal from land it owned and in Year 1, it teamed up with a lab to assist with this endeavor. The lab's assignment included: (1) site selection, site characterization, preliminary environmental hazard identification, assessment, and recommendations; (2) site development planning; and (3) project management activities. Successful completion of the first two tasks would contribute to Taxpayer's ability to successfully field a test burn and start toward Pilot Project, and assist in the engineering design and execution of Process pilot.

On Date 1, Taxpayer created a disregarded entity, LLC, which then entered into a partnership with Company 1, a Process developer that holds certain geographical rights to needed technology. The purpose of the partnership was to carry out the Process project. On Date 2, Taxpayer contracted with Company 3 to provide consulting services involving the exploration and development of coal resources on Taxpayer's land. Company 3 also conducted a geological mapping project, a two-phase core-drilling program in Years 2 and 3, and a 2D seismic survey in Years 3 and 4.

On Date 3, Taxpayer also entered into a contract with Company 4 to do geophysical surveys and seismic testing in the bores drilled by Company 3. Neither the Company 4 nor Company 3 contracts include any language or provision regarding Process, the research these companies are to conduct, nor alternatives to consider to resolve any uncertainties regarding the Process project.

For Years 2 and 4, Taxpayer treated a portion of its expenses relating to the Company 3 and Company 4 contracts as R&E expenses under §174, and on its Years 2, 3, and 4 returns, claimed credits under §41 for another portion of its R&E expenses. Taxpayer hired Accounting Firm to analyze its costs related to the Process project to determine their eligibility for §174 R&E deductions and §41 research credits. Accounting Firm concluded that Taxpayer's costs were more likely than not eligible for both §174 and §41 treatment.

On Date 4, Company 2 provided an update regarding the status of the Process project. The update explains in depth the site selection process, which focused on the geology, hydrology, and rock mechanics assessment of the target Pilot area. The update says that the site-selection process determination by Company 2 was based on whether a candidate site was suitable for the application of Technology and for the potential development of a commercial scale Process plant.

The main issue in the CCA is whether Taxpayer's expenses in connection with its potential Process plant are R&E expenses deductible under §174, or are barred from this deduction under §174(d) as exploration expenses (and instead deductible under §617 if Taxpayer so elects). This issue in turn depends on the resolution of the following sub-issues.

Taxpayer claimed that it cannot separate its exploration costs from its overall project because the two are intertwined. It only contracted with Companies 3 and 4 to conduct the drilling and surveying in connection with Taxpayer's Process project. Taxpayer argued that since the goal of the Process project was to develop a commercial Process plant and to improve the Process, all steps it took to accomplish those goals were incidental to such development or improvement. As such, Taxpayer asserted that contract expenses paid to Companies 3 and 4 were deductible as R&E expenses under §174(a).

Disagreeing with Taxpayer, the CCA says that Revenue Ruling 74-67, 1974-1 CB 63 and Revenue Ruling 75-122, 1975-1 CB 87, both dealing with mining-related R&E expenses, provide a strong argument that the expenses at issue are §174(d) exploration costs. The CCA says the rulings stand for the proposition that, when a taxpayer is involved in a project that includes discrete activities, the purpose for each activity must be analyzed in determining whether the expenses relating to that activity qualify as R&E expenses.

Additionally, the CCA points to Regulation §1.174-2(a)(1), which notes that the determination of "whether expenses qualify as research or experimental expenses depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed." According to the CCA, this sentence suggests that the determination of whether expenses can be deducted under §174(a) is made by looking at the purpose of each independent activity as opposed to the purpose of the entire project to which the activity relates. In other words, says the CCA, the regulation validates the analyses in Revenue Ruling 74-67 and Revenue Ruling 75-122.

The issue here is whether §174(d) applies only if a taxpayer's sole purpose for an expense paid or incurred is ascertaining, location, extent, or quality of any deposit of ore or other mineral (Taxpayer's position), or it applies if such a purpose is merely one of the taxpayer's purposes for the expense (IRS's position).

Taxpayer argued that its primary purpose was to eliminate or reduce technical uncertainty incident to the design or development of the Process, thus qualifying the expenses for deduction under §174. It admitted that a secondary consequence of collecting data was to improve its knowledge as to the extent or quality of the known coal deposits (i.e., exploration), but Taxpayer argued that IRS was incorrectly focusing on this secondary consequence instead of its primary motivation.

The CCA's position is that if Congress had intended the §174(d) exclusion to apply narrowly, as Taxpayer suggested (i.e., to apply only if the primary purpose of the expense was exploration), it would have so specified, using limiting language to describe the expenses to which §174(d) applies. Moreover, a strict reading of §174(d) in the context of §174 suggests that if "any" expenditure is paid or incurred for "the" purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, then it does not matter how important that purpose is relative to any purpose for the expense. In such a case, the taxpayer is not entitled to a deduction for the expense as an R&E expense.

Over the years, Congress amended §174 numerous times without ever changing the language of §174(d). Congress could have clarified §174(d) so that it only applies if a taxpayer's "principal purpose," "significant purpose," or "primary purpose" is for exploration, which is language Congress has used in other Code sections. Accordingly, the CCA concludes that Taxpayer's argument that its alleged primary purpose is more important than its secondary purpose for §174(d) purposes is without merit. Taxpayer's expenses incurred in its Process project cannot be deducted as R&E expenses under §174(a) because they are exploration costs under §174(d).

The CCA also concludes that:

1. Taxpayer's contract costs to Companies 3 and 4 are deductible under §617. The rule preventing a §617 deduction for expenses attributable to minerals for which no percentage depletion is allowable under §613 does not apply since Taxpayer's Process is an activity that subsumes the coal extraction process-a mining activity. The definition of "mining" under §613(c) includes the extraction of the ores or minerals from the ground.

2. Taxpayer still had time to make the §617 election. In general, the §617 election may be made at any time before the expiration of the period prescribed for filing a claim for an income tax credit or refund for the tax year in which the expenses were paid or incurred. (§617(a)(2)) Under §6511(c)(1), where IRS and the taxpayer agree to a §6501(c)(4) extension to the period for assessment, the period for filing a timely claim for credit or refund does not expire prior to 6 months after the expiration of the agreement or any extension of time for which IRS may make the assessment

3. The expenses incurred by Taxpayer are not R&E expenses under §174 but are mining exploration expenses under §174(d). As a result, the expenses do not qualify for the §41 research credit as the requirements of §41(d)(1)(A) have not been met.

Chief Counsel Advice 201713010.

Where a regulatory agency approved a merger subject to certain conditions, the costs of activities undertaken in satisfaction of the regulatory agency's conditions were not necessarily required to be capitalized under Regulation §1.263(a)-5 as amounts paid to facilitate the transaction.

To be deductible as an ordinary and necessary business expense under §162, an expense must be paid or incurred during the tax year, sustained in carrying on a trade or business, and be an ordinary and necessary expense. Under §263(a), an expense must be capitalized if incurred for new buildings, permanent improvements, or betterments made to increase the value of any property or estate.

Regulation §1.263(a)-5(a) provides that amounts paid or incurred to facilitate an acquisition of a trade or business, a change in the capital structure of an entity, and certain other transactions-including a restructuring, recapitalization, or reorganization of the capital structure of a business entity-must be capitalized. Regulation §1.263(a)-5(a) provides that transactions that must be capitalized include "an acquisition by the taxpayer of an ownership interest in a business entity if, immediately after the acquisition, the taxpayer and the business entity are related within the meaning of §267(b)."

Regulation §1.263(a)-5(b) provides that an amount is paid to facilitate a transaction for this purpose if the amount is paid in the process of investigating or otherwise pursuing the transaction. This determination is made based on all the facts and circumstances. In determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid but for the transaction is relevant, but not determinative. An amount paid to another party in exchange for tangible or intangible property is not an amount paid to facilitate an exchange.

The preamble to the proposed regulations (67 F.R. 77701-01, 2003-1 C.B. 373) which first introduced the concept of costs that facilitate a transaction, provides further discussion concerning the relevance of the fact that an amount would not have been paid but for the transaction: the facilitate standard is intended to be narrower in scope than a "but for" standard. Thus, some transaction costs that arguably are capital under a "but for" standard, such as costs to downsize a workforce after a corporate merger (including severance payments) or costs to integrate the operations of merged businesses, are not required to be capitalized under a "facilitate" standard. While such costs may not have been incurred "but for" the merger, the costs do not facilitate the merger itself.

Regulation §1.263(a)-5(e)(2)(iv) lists "obtaining regulatory approval" as an amount paid that is "inherently facilitative." Under Regulation §1.263(a)-5(e)(2)(iv), obtaining regulatory approval includes "preparing and reviewing" regulatory filings. It also includes attorneys' fees to defend against lawsuits filed by regulators to halt a transaction, even if those fees are incurred after the transaction is completed. (See Regulation §1.263(a)-5(l), Ex. 10.)

Taxpayer included among its subsidiaries regulated C companies. Company E owned, among other interests, a regulated C company, Company H. Taxpayer and Company E proposed a merger, which required the approval of Regulatory Board.

Taxpayer and Company E submitted their application to Regulatory Board for approval of the merger. There were numerous submissions and hearings on the proposed merger during the following six months. Taxpayer and Company E eventually entered into a settlement with the State K, City J, and certain other interested parties in connection with the regulatory proceedings.

The Regulatory Board approved the merger subject to the following conditions:

1. An Amount N rate credit for each Company H customer. The rate credit reduced Company H's revenue by Amount O in Year 2. Taxpayer made an Amount P capital contribution to Company H to fund the rate credit. The rate credit was made to customers of record on Date.

2. An Amount Q contribution to a customer investment fund. The fund was set up to provide long-term benefits to Company H customers in the form of V.

3. Payments totaling Amount R to State K for development of an S.

4. A commitment to contribute Amount T per year for U to charitable organizations and traditional local community support within State K.

Company E was merged into Taxpayer in a stock for stock transaction, and Company H became a wholly-owned subsidiary of Taxpayer.

Where a regulatory agency approves a merger subject to certain conditions, are the costs of activities undertaken in satisfaction of the regulatory agency's conditions per se required to be capitalized under Regulation §1.263(a)-5 as amounts paid to facilitate a transaction?

In the CCA, IRS concluded that, while it would not be unreasonable to conclude that the costs at issue were incurred in order to obtain regulatory approval for the merger, the mere fact that costs would not have been incurred but for the closing of a transaction identified in Regulation §1.263(a)-5(a) was not sufficient to determine that the costs facilitated the transaction. However, IRS also found that in this case, it did not have sufficient information to determine whether Taxpayer incurred the costs at issue solely on account of the merger.

In requiring capitalization of the costs at issue, the examining agent appeared to rely primarily on a "but for" test to argue that the costs in question were capital expenditures under Regulation §1.263(a)-5. But, as noted in the preamble to the proposed regulations, the facilitate standard is meant to be narrower than a "but for" standard.

The CCA reasoned that not all costs incurred because of a merger are facilitative for purposes of Regulation §1.263(a)-5. Regulation §1.263(a)-5(b) explains that costs are facilitative if they are incurred in "investigating or otherwise pursuing" the transaction. The costs specifically identified as facilitative in Regulation §1.263(a)-5(a) are "deal costs," that is, amounts paid to service providers, such as investment bankers, attorneys, and transfer agents, who undertake financial, legal, investigatory, or administrative activities that are generally provided exclusively for the purpose of pursuing a transaction but which otherwise are not general operating costs of the target or acquirer.

In the CCA, IRS rejected the examining agent's contention that because Regulatory Board was required to approve the proposed merger and ordered Taxpayer to pay the costs in question as a condition to its approval, under Regulation §1.263(a)-5(e)(2)(iv) these costs were included with the costs incurred in obtaining regulatory approval. The CCA determined that while the costs of obtaining regulatory approval include the costs of preparing for and appearing before a regulatory board, the phrase "regulatory approval" should not be read so broadly so as to include any and all costs to address conditions that might be imposed by regulators.

In the CCA, IRS noted that the costs were not analogous to deal costs paid to service providers who assist with financing, investigating, documenting, or otherwise administratively facilitating the transfer of property. Rather, most of the costs identified were in the nature of annual operating costs that a certain type of company would incur as part of its normal business operations. For example, regulators commonly require these companies to charge set amounts to customers or provide customers with various credits, and these companies frequently make annual contributions to charitable organizations or for local community support.

In this case, the CCA found that three of the four costs at issue were commonly and frequently required by regulators and were annually incurred by such companies as part of their ordinary and recurring business operations. In addition, the fact that Company E was previously making annual donations in the same amount as Company E's commitment to make future donations suggested a continuation of Company E's prior business practice. Finally, the fourth cost appeared to be, at least in part, in exchange for intangible property.

In the case of the costs that may not be in the nature of annual operating costs, the payments to State K for the development of an S-while not entirely clear-appeared to indicate that the taxpayer may receive the right to intangible property as a result of the payment. Under Regulation §1.263(a)-5(b)(1), an amount paid to another party in exchange for intangible property is not an amount paid to facilitate a merger.

PLR 201730018.

IRS has ruled on various aspects of the conversion of a nongrantor trust to a grantor trust, including holding that such a conversion is not a taxable transfer of property.

§671 provides that where it is specified in subpart E of the Code that the grantor or another person is treated as the owner of any portion of a trust, there then is included in computing the taxable income and credits of the grantor or the other person those items of income, deductions and credits of the trust that are attributable to that portion of the trust to the extent that such items would be taken into account in computing taxable income or credits of an individual.

§675(4) provides that the grantor is treated as the owner of any portion of a trust over which there is a power of administration exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of §675(4), the term "power of administration" includes a power to reacquire the trust corpus by substituting other property of an equivalent value.

Revenue Ruling 77-402, 1977-2 CB 222, holds that when the grantor and owner of a trust which holds a partnership interest subject to liabilities, renounces all grantor trust powers over that trust during life, the grantor is treated as having transferred the interest and will recognize gain or loss. The ruling states that the result would also be the same if the trust were treated as a grantor trust by reason of powers exercisable by a party other than the grantor and ceased to be a grantor trust upon the release or renunciation of those powers by such other party or upon the expiration or lapse of such powers.

Revenue Ruling 85-13, 1985-1 CB 184, holds that a grantor who acquired the corpus of a trust in exchange for an unsecured promissory note was considered to have indirectly borrowed the trust corpus, resulting in grantor trust treatment. As a result, the transfer of trust assets to the grantor was not a sale for federal income tax purposes. The ruling concluded that the grantor became the owner of the trust corpus which he had indirectly borrowed and thus was taxable on the trust's income and, as the deemed owner of the trust assets, could not engage in a transaction with the trust that would be respected for income tax purposes. It did not conclude that the grantor realized the amount of the indirect borrowing or any portion of that amount as income.

§4947(a)(2) provides that-in the case of a trust which is not exempt from tax under §501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in §170(c)(2)(B), and which has amounts in trust for which a deduction was allowed under §170 (or other charitable deduction provision)- §4941 applies as if such trust were a private foundation.

§4941 imposes an excise tax, paid by the disqualified person, on each act of self-dealing between a private foundation and a disqualified person for each year in the taxable period, and requires correction of the act of self-dealing. §4941(d)(1)(E), provides that an act of self-dealing includes any direct or indirect transfer to, or for the use by or for the benefit of, a disqualified person of the income or assets of a private foundation. Revenue Procedure 2007-45, 2007-2 CB 89, §8.09(1), provides that the exercising of a power to substitute trust assets as described in §675(4) may result in an act of self-dealing under §4941.

Under §4946(a), the term "disqualified person" includes a substantial contributor to the foundation, a foundation manager, or a family member. §4946(d) provides that members of family include only the individual's spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren, and great grandchildren.

§170(f)(2)(B) provides that no charitable deduction is allowed under §170 for the value of any interest in property (other than a remainder interest) transferred in trust unless the interest is in the form of a guaranteed annuity or the trust instrument specifies that the interest is a fixed percentage distributed yearly of the fair market value of the trust property (to be determined yearly) and the grantor is treated as the owner of such interest for purposes of applying §671.

Revenue Procedure 2007-45, §8.01(2), provides that the donor to a grantor charitable lead annuity trust may claim a federal income tax charitable deduction under §170(a) in the year that assets are irrevocably transferred to the trust.

Grantor, as settlor and initial trustee, created Trust pursuant to Agreement. Agreement provides that until the X anniversary of the initial contribution date, an amount equal to the annuity amount will be distributed to Charity. Trust is seeking to amend Agreement. The amended article permits the Substitutor to have the power, exercisable at any time in a nonfiduciary capacity (within the meaning of §675(4)), without the approval or consent of any person in a fiduciary capacity, to acquire or reacquire Trust principal by substituting other property of an equivalent value, determined as of the date of such substitution. Substitutor is not a trustee of Trust. Substitutor and Grantor are siblings.

Whether, assuming the amendment is effected:

1. There was a conversion from a nongrantor to a grantor trust;

2. The conversion of Trust from a nongrantor trust to a grantor trust is a taxable transfer of property held by Trust to Grantor as settlor;

3. The conversion of Trust from a nongrantor trust to a grantor trust is an act of self-dealing that would result in a tax under §4941; and

4. The conversion of Trust from a nongrantor trust to a grantor trust would result in an income tax charitable deduction for Grantor in the year of conversion under §170.

Under §675(4), the power given to Substitutor makes the trust a grantor trust.

IRS concluded that there was no transfer of property when the trust was converted to a grantor trust.

IRS noted that Revenue Ruling 77-402 concludes that the lapse of grantor trust status during the grantor-owner's life may have income tax consequences but does not impose such consequences on a non-grantor trust that becomes a grantor trust. Revenue Ruling 85-13 describes the income tax effects of a non-grantor trust becoming a grantor trust, which effects did not include the realization or recognition of any income by the grantor-owner by reason of the conversion.

IRS said, given the lack of authority imposing such consequences, the conversion of Trust from a non-grantor trust to a grantor trust will not be a transfer of property to Grantor from Trust under any income tax provision.

IRS concluded that the conversion of the trust will not be an act of self-dealing under §4941, since there is no disqualified person involved.

Trust is a split interest trust described in §4947(a)(2) and is subject to the self-dealing rules described in §4941. However, in order for an act of self-dealing under §4941 to occur, the act needs to occur between a disqualified person as described in §4946 and a private foundation. The Substitutor is not considered a disqualified person under §4946(a) because Substitutor, as a sibling of Grantor, is not treated as a family member as described in §4946(d).

IRS held that upon the conversion of Trust from a nongrantor trust to a grantor trust, the owner of the grantor trust can claim a federal income tax charitable deduction under §170(a) only if property has been transferred to the grantor trust from the nongrantor trust. Because the conversion of Trust from a nongrantor trust to a grantor trust is not a transfer of property held by Trust for income tax purposes, Grantor is unable to take an income tax charitable deduction under §170(a).

PLR 201710006.

IRS approved the way an auto racing team handled its disposition of auto parts for gain and loss purposes. Because of the unique nature of the autos raced in the sport, IRS ruled that each part used to build a taxpayer's race cars for each specific race was the appropriate asset for disposition purposes.

A taxpayer disposes of an asset when it permanently withdraws the asset from use in its trade or business, including by retiring or physically abandoning the asset. (Regulation §1.168(i)-8(b)(2) A disposition also occurs when an asset is transferred to a supplies, scrap, or similar account. The facts and circumstances of each disposition are considered in determining what is the appropriate asset disposed of. (Regulation §1.168(i)-8(c)(4))

The following rules generally apply when an asset is disposed of during a tax year:

1. Gain or loss must be recognized if an asset is disposed of by sale, exchange, or involuntary conversion.

2. If an asset is disposed of by physical abandonment, loss generally must be recognized in the amount of the adjusted depreciable basis of the asset at the time of the abandonment, taking into account the applicable depreciation convention. For a loss from physical abandonment to qualify for recognition, the taxpayer must intend to discard the asset irrevocably so that the taxpayer will neither use the asset again nor retrieve it for sale, exchange, or other disposition.

3. If an asset is disposed of other than by sale, exchange, involuntary conversion, physical abandonment, or conversion to personal use (as, for example, when the asset is transferred to a supplies or scrap account), gain is not recognized. Loss must be recognized in the amount of the excess of the adjusted depreciable basis of the asset at the time of the disposition, taking into account the applicable depreciation convention, over the asset's fair market value (FMV) at the time of the disposition, taking into account the applicable depreciation convention. (Regulation §1.168(i)-8(e))

Under Regulation §1.168(i)-8(f)(1), the adjusted basis of an asset disposed of for computing gain or loss is its adjusted depreciable basis at the time of the asset's disposition, as determined under the applicable convention for the asset. And under Regulation §1.168(i)-8(g)(1), except for assets disposed of in a multiple asset account or disposition of a portion of an asset), a taxpayer must use the specific identification method of accounting to identify which asset is disposed of by the taxpayer. Depreciation ends for an asset at the time of its disposition, as determined under the applicable convention for the asset. (Regulation §1.168(i)-8(h)(1))

In general, Regulation §1.168(i)-8 does not apply to dispositions of assets included in a general asset account.

Under §1012, the basis of property generally is its cost. The cost is the amount paid for the property in cash or other property. (Regulation §1.1012-1(a))

Taxpayer's team participates in a type of event called "F racing" (possibly Formula 1 racing), where teams do not build, acquire, or carry a finished, complete car. Instead, they build or acquire parts that they then assemble and reassemble into different racing cars over a race season, with each entrant registering a particular assemblage (aka racing car entry) for each event. After each event, Taxpayer's F team will strip down the racing car used in that event into different parts which the team will inspect, repair, refinish, repaint, and/or replace as appropriate.

Most parts are useless for racing purposes after a season ends because they are subjected to high stress levels, are damaged or destroyed, or become obsolete. At the end of a racing season, some parts will be scrapped outright. The other obsolescent or surviving parts will be incorporated into assemblages used for a show or pit car. As a practical matter, a show or pit car will incorporate at the very least those elements necessary to provide a realistic practice experience for pit stop crews. A show or pit car need not, and rarely will, incorporate the highly-specialized parts suitable only for racing. In no case does the team use the parts incorporated in a show or pit car for their original function, which is racing.

Taxpayer's F team uses sophisticated software to identify, inventory, and track the history of each part in an assemblage. Taxpayer will capitalize the amounts paid or incurred to produce each racing car and each show or pit car as the costs of producing separate units of tangible property under Regulation §1.263(a)-2(d)(1). It also will capitalize to each racing car and each show or pit car that Taxpayer produces, all direct costs and a properly allocable portion of indirect costs that directly benefit or are incurred by reason of the performance of such production activity. None of its racing, show or pit cars, nor any of its parts, will be in a general asset account under Regulation §1.168(i)-1. Finally, the following will be assigned to a supplies or scrap account: damaged parts; obsolescence parts and worn parts that become useless for incorporation in any subsequent racing car or a show or pit car; and obsolescence parts and surviving parts that can still be incorporated in any subsequent racing car or a show or pit car.

IRS says that, due to the unique facts of Taxpayer's situation, each part that it owns and uses to build its race cars for each specific race is the appropriate asset for disposition purposes under Regulation §1.168(i)-8(c)(4). In addition, a disposition occurs under Regulation §1.168(i)-8(b)(2) when Taxpayer disassembles each racing car entry into its various parts and permanently withdraws those parts from its business.

IRS agreed with Taxpayer's request that, for any part of a racing car entry that is not to be reused to produce another racing car entry or a show or pit car:

1. Gain or loss is recognized if the part is disposed of by sale, exchange, or involuntary conversion.

2. Loss is recognized if the part is disposed of by physical abandonment.

3. Gain is not recognized if the part is disposed of by a transfer of such part to a scrap or similar account. Loss is recognized if the part is disposed of by a transfer of such part to a scrap or similar account, and the loss is recognized in the amount of the excess of the adjusted depreciable basis of the part at the time of the disposition (taking into account the applicable convention) over the part's FMV at the time of the disposition (taking into account the applicable convention).

IRS also ruled that gain is not recognized for any part of a racing car entry which is to be reused to produce another racing car entry or a show or pit car and that is disposed of by a transfer of the part to a supplies or similar account. Loss is recognized for any part of a racing car entry which part is to be reused to produce another racing car entry or a show or pit car and that is disposed of by a transfer of such part to a supplies or similar account. The loss is recognized in the amount of the excess of the adjusted depreciable basis of the part at the time of the disposition (taking into account the applicable convention) over the part's FMV at the time of the disposition (taking into account the applicable convention).

IRS also ruled that if, after a racing car entry is disassembled into various parts, and a part is (or parts are) transferred to a supplies, scrap, or similar account, the basis of each such part in the account before the application of §263A is as follows:

a. If no gain was recognized on the disposition of the part when the racing car entry was disassembled into various parts, the part's adjusted depreciable basis at the time of disposition (taking into account the applicable convention); and

b. If a loss was recognized on the disposition of the part when the racing car entry was disassembled into various parts, the part's FMV at the time of disposition (taking into account the applicable convention).

PLR 201706009.

Wireless communications towers are of like-kind to above- and below-ground cable distribution systems. As a result, these assets can be exchanged tax-free under the like-kind exchange rules.

If specific identification and replacement period requirements set forth in §1031 are met, gain or loss is not currently recognized when property held for productive use in a trade or business or for investment is exchanged for property of like-kind that will be held for productive use in a trade or business or for investment.

Under the regulations, "like-kind" refers to the nature or character of the property, not to its grade or quality. One kind or class of property may not be exchanged for property of a different kind or class. (Regulation §1.1031(a)-1(b))

In Chief Counsel Advice, IRS has said that federal income tax law, not state law, controls whether exchanged properties are of like-kind for §1031 purposes, and under the §1031 rules, properties are generally of like-kind if they are of same nature and character. Although state law property classifications are relevant for determining if property is real or personal, they are not determinative of whether properties are of the same nature and character, which should be determined by considering all facts and circumstances. (Chief Counsel Advice 201238027)

Taxpayer is a communications services provider offering communications infrastructure to its customers. It currently owns fee simple or long-term leasehold interests in multiple wireless communication tower sites across the nation. Each tower site consists of fencing around the tower site, an antenna support structure for mounting antennas that are affixed to the land by a concrete foundation and attachment hardware (such as bolts and lashings), a nearby equipment hut with HVAC systems installed in the hut, and the land underlying the site itself ("Towers"). All Towers are permanently affixed to the land or would be extensively damaged if removed.

Taxpayer wants to exchange its Towers for Cable Distribution Systems. These are fiber-optic and copper cables installed either above or below ground and various other associated properties, including telephone poles for carrying the cables, underground conduits, concrete pads, attachment hardware, pedestals, guy wires, and anchors. The Cable Distribution Systems are permanently affixed to the land or are intended never to be removed until the end of their respective useful lives.

Taxpayer asked IRS to rule that the Towers and Cable Distribution Systems were of a like-kind for §1031 purposes.

Observation: Although the PLR does not say so, Taxpayer's concern may have been whether, for example, Towers treated as real property in State A could be swapped under the like-kind rules for Cable Distribution Systems located in State B, that are classified as personal property in that state.

The PLR cites a number of cases (e.g., *Fleming Clemente*, TC Memo 1985-367, *Oregon Lumber,* (1953) 20 TC 192) for the proposition that state law property classifications are not the sole determiner of whether two sets of property are of like-kind for §1031 purposes.

In Taxpayer's case, the Towers and the Cable Distribution Systems transmit or support the transmission of telecommunication signals across distances. The assets are not used for other activities. In addition, both the Towers and the Cable Distribution Systems are, or are intended to be, permanently affixed to land. Under these facts, the PLR concludes that Taxpayer's Towers and the Cable Distribution Systems are like-kind property for §1031 purposes.

The conclusion of the PLR spells out that Taxpayer's real property improved with Towers (including fencing around the tower site, an antenna support structure for mounting antennas attached to the land by a concrete foundation and attachment hardware (such as bolts and lashings), nearby equipment huts with HVAC systems installed in the huts and all other structural components of Towers and the huts that are fully installed) is of like-kind to the real property improved with Cable Distribution Systems (copper or fiber optic cables, telephone poles, underground conduits, concrete pads, attachment hardware, pedestals, guy wires, and anchors that are fully installed).

The PLR notes that its holding applies only to the Towers and the Cable Distribution Systems that are affixed or embedded in real property held in fee simple or similar interest or under a long-term lease, easement, right of way or similar long-term right of use arrangement, in each case lasting for 30 years or more including optional renewal periods exercisable by the tenant or right-of-use holder.

Observation: The significance of the 30-year-or-more term is that under Regulation §1.1031(a)-1(c), a leasehold interest of at least 30 years is of like-kind to a fee interest in real property.

PLR 201701009.

Three individuals who owned a patent through their wholly owned limited liability company (LLC) classified as a partnership were entitled to long-term capital gain treatment under §1235. They had sold all substantial rights to the patent to a third party and received a termination payment paid by a third party to terminate its payment obligations under the agreement.

Under §1235(a), a transfer (other than by gift, inheritance, or devise) of all substantial rights to a patent, or an undivided interest which includes a part of all of the rights, by any holder is considered the sale or exchange of a capital asset held for more than one year. That's true regardless of whether or not payments in consideration of the transfer are: (1) payable periodically over a period generally coterminous with the transferee's use of the patent, or (2) contingent on productivity, use, or disposition of the property transferred.

Under Regulation §1.1235-2(b)(1), "all substantial rights to a patent" means all rights (whether or not then held by the grantor) which are of value when the rights to the patent (or an undivided interest therein) are transferred. "All substantial rights to a patent" does not include a grant of rights to a patent: (i) which is limited geographically within the country of issuance; (ii) which is limited in duration by the terms of the agreement to a period less than the remaining life of the patent; (iii) which grants rights to the grantee, in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant; or (iv) which grants to the grantee less than all the claims or inventions covered by the patent which exist and have value at the time of the grant.

Any individual whose efforts created the patent is a holder. While a partnership cannot be a holder, each member of the partnership who is an individual may be a holder as to his share of the patent owned by the partnership. (Regulation §1.1235-2(d)) For example, if an inventor who is a member of a partnership composed solely of individuals uses partnership property in the development of his invention with the understanding that the patent when issued will become partnership property, each of the inventor's partners during this period would qualify as a holder. If, in this example, the partnership were not composed solely of individuals, nevertheless, each of the individual partner's distributive shares of income attributable to the transfer of all substantial rights to the patent, or an undivided interest therein, would be considered proceeds from the sale or exchange of a capital asset held for more than one year.

PRS is a state law limited liability company classified as a partnership for federal tax purposes. The only partners in PRS are PR1, PR2, PR3, and PR4, all individuals within the meaning of §1235. On Date 1, PRS and LLC, an unrelated entity, entered into Agreement 1, under which PRS transferred its Rights in Product to LLC in consideration for LLC's payments, based on the sales of Product, to PRS. The transfer of its PRS's rights in Product under Agreement 1 was a transfer of property consisting of all substantial rights to a patent within the meaning of §1235. In Year 1 and Year 2, PRS and its partners reported the payments received from LLC as payments from the sale or exchange of a capital asset held for more than one year under §1235.

On Date 2, PRS and LLC entered into Agreement 2, by which they terminated Agreement 1, pending the acquisition of LLC by an unrelated third party. Agreement 2: (a) confirmed that PRS had transferred its rights in Product to LLC under Agreement 1; and (b) required that LLC pay PRS a termination payment, of which a portion was allocated as final payment for the termination of LLC's payment obligations under Agreement 1.
PRS asked IRS to rule that the portion of the termination payment that was allocated as final payment for the termination of LLC's payment obligations under Agreement 1 qualifies as long-term capital gain under §1235.

Based on the information submitted and the representations made, and as long as each individual partner qualifies as a holder, IRS concluded that the portion of the termination payment allocated as final payment for the termination of LLC's payment obligations under Agreement 1 qualifies as long-term capital gain under §1235 as to each individual partner's distributive share of income attributable to the transfer.

The PLR says, however, that it expresses or implies no opinion concerning whether PRS's transfer of its rights in Product under Agreement 1 was a transfer of property consisting of all substantial rights to a patent within the meaning of §1235.

PLR 201650014.

Some of a construction contractor's soil grading and compaction with respect to the development of dwelling units should be considered construction of a portion of the dwelling units for purposes of the home construction contract exception to the requirement that the percentage-of-completion method (PCM) be used to account for long-term contracts.

§460(a) generally requires use of PCM to account for long-term contracts, as that latter term is defined in §460(f). §460(e)(1)(A), however, exempts "any home construction contract" from the general rule. A taxpayer performing construction services pursuant to a "home construction contract" may report income from that construction activity using the completed contract method (CCM). (Regulation §1.460-4(c))

Under PCM, contract price is reported as contract costs are incurred, based on the proportion of incurred to estimated total costs. (§460(b)(1)(A)) Under CCM, contract price and costs are reported upon contract completion. (Regulation §1.460-4(d))

Under §460(e)(4), a construction contract is "any contract for the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property." §460(e)(6)(A) defines "home construction contract" as any construction contract if 80% or more of the estimated total contract costs are reasonably expected to be attributable to construction activities with respect to "(i) dwelling units (as defined in §168(e)(2)(A)(ii)) contained in buildings containing 4 or fewer dwelling units (as so defined), and (ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units." This test is often referred to as "the 80-percent test."

For purposes of §460(e)(6)(A), a "dwelling unit" is defined at §168(e)(2)(A)(ii) as "a house or apartment used to provide living accommodations in a building or structure." For purposes of the 80-percent test, Regulation §1.460-3(b)(2)(iii) allows taxpayers to include in the costs of dwelling units their allocable share of the costs of common improvements that taxpayer is required to build, by contract or by law, on the tract of land containing the dwelling units.

Taxpayer, a C Corporation, actively participates in private sub-division housing projects. It enters into contracts that require Taxpayer to make a variety of heavy construction improvements necessary for the development of a housing sub-division, including grading and compacting soil for construction of homes.

Taxpayer's grading activities include rough grading of the sub-division and fine grading of the "pad" area of an individual lot where the foundation of a house will be constructed. State and county building codes require the testing of soil in a sub-division, in some cases on a lot-by-lot basis. Taxpayer performs grading and soil compaction of the pad area to required densities and depths in accordance with engineering surveys that are completed in order to comply with these requirements. In some cases, clay or organic soil must be replaced with more stable soil. The specific grading and compaction of the pad area required are based on the structure that will be built on the lot and environmental factors such as water runoff. Taxpayer's work is covered by home warranties, and Taxpayer has paid claims related to its work on pad areas. Taxpayer's contracts generally do not exceed four years in duration.

IRS concluded that grading and soil compaction of the pad area necessary for the construction of foundations for houses are construction activities with respect to dwelling units per §460(e)(6)(A). Taxpayer's work is regulated by state and local building codes and is the subject of home warranties. The grading and soil compaction of the pad area necessary for the construction of the foundations are as essential to support of the houses as the foundations themselves and should be considered construction of a portion of the dwelling units.

IRS found further support for its conclusion in authorities addressing the issue of whether the cost of land preparation can be included in the basis of a building used in a trade or business or held for the production of income, and therefore is depreciable. Courts have found and IRS has ruled that when grading (that is, land preparation) is so closely associated with a specific depreciable structure that the land preparation would be retired, abandoned, or replaced contemporaneously with that depreciable structure, the cost of the land preparation is depreciable and may be part of the cost basis of the structure. (*Eastwood Mall, Inc.,* (DC OH 1995) 75 AFTR 2d 95-2291; Revenue Ruling 2001-60, 2001-2 CB 587; and Revenue Ruling 68-193, 1968-1 CB 79)

In addition, IRS observed that, in all likelihood, replacement of a rental house and its foundation would require the contemporaneous physical destruction of the pad, so that the cost of the pad is part of the cost basis of the rental house. For purposes of §460(e)(6)(A), the pad therefore may be considered part of the dwelling unit.

IRS also noted that rough grading of the lot or clearing trees would not qualify as construction of a dwelling unit because those are non-depreciable improvements to land.

Observation: IRS said that temporary or final regulations pertaining to one or more of the issues addressed in this memorandum have not yet been adopted. Therefore, this memorandum will be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusions in the memorandum.

PLR 201648013.

Under the §1031 rules, a taxpayer will not be in actual or constructive receipt of relinquished property proceeds where the taxpayer's qualified intermediary (QI) must use the proceeds to repay loans secured by the relinquished property. IRS also ruled that the QI's repayment of relinquished property debt with relinquished property proceeds will be treated as liability relief for purposes of the boot-netting rules of Regulation §1.1031(b)-1(c).

In general, no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of a like kind which is held either for productive use in a trade or business or for investment. (§1031) Qualified intermediaries (QIs) may be used to structure like-kind exchanges using qualified exchange accommodation arrangements. (Regulation §1.1031(k)-1(g)(4))

Under Regulation §1.1031(k)-1(f)(1), gain or loss may be recognized in the transfer of relinquished property in a deferred exchange if the taxpayer actually or constructively receives money or other property before he actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before he actually receives the like-kind replacement property, the transaction is a sale and not a deferred exchange even though the taxpayer ultimately may receive like-kind replacement property.

Under §1031(b), in an exchange that would otherwise qualify as like-kind but for the fact that the property received in the exchange includes non like-kind property or money, the gain (if any) to the recipient must be recognized, but not in excess of the sum of the money and the fair market value of the non like-kind property. Under Regulation §1.1031(b)-1(c), consideration in the form of an assumption of liabilities (or a transfer subject to a liability) is treated as "other property or money" for this purpose. If each party either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of other property or money, consideration given in the form of an assumption of liabilities (or the receipt of property subject to a liability) is offset against consideration received in the form of an assumption of liability (or transfer subject to a liability). Thus, when there are mortgages on both sides of the transaction, the mortgages are netted and the difference is recognized gain (boot) to the party transferring the property with the larger mortgage.

In *Barker* (1980), 74 TC 555, the Tax Court held that proceeds from the disposition of the relinquished property can be used to pay off debt on that property without triggering gain if the taxpayer incurs or assumes a liability on the purchase of the replacement property that equals or exceeds the debt on the relinquished property. The taxpayer in Barker received cash in the exchange but was contractually obligated by the transferee of the relinquished property to use the cash to pay off the relinquished property debt. Thus, the Tax Court held that the boot netting principle in Regulation §1.1031(b)-1(c) covers not just assumptions of debt but also situations in which the proceeds of the relinquished property are used to pay off the relinquished property debt.

Revenue Procedure 2003-39, 2003-1 CB 971, §5.02, provides that a taxpayer engaged in a Like-Kind Exchange program (LKE program) will not be considered in actual or constructive receipt of proceeds from the sale of relinquished property deposited into or held in a joint bank, trust, escrow, or similar account in the name of the taxpayer and the QI, or in an account in the name of a third party (other than a disqualified person under Regulation §1.1031(k)-1(k)) for the benefit of both the taxpayer and the QI if: (1) the account is used to collect, hold, and/or disburse proceeds arising from the sale of relinquished property for the benefit of the QI; (2) the agreement setting forth the terms and conditions with respect to the account requires authorization from the QI to transfer proceeds from the sale of relinquished properties out of the account; and (3) the agreement setting out the terms of the taxpayer's and the QI's rights in the account expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of proceeds from the sale of relinquished property held in the joint account.

Under Revenue Procedure 2003-39, 2003-1 CB 971, §5.03, a taxpayer engaged in an LKE Program is not in actual or constructive receipt of money or other property as a result of transferring relinquished property solely because an amount owed by the taxpayer to the buyer (other than a lease security deposit) is netted against the sale price of the relinquished property, if, as required by the master exchange agreement (MEA), funds equal to the full amount of sales proceeds from the relinquished property are transferred to or for the benefit of the QI by the opening of the next day's business. Likewise, a taxpayer acquiring replacement property in a like-kind exchange is not in actual or constructive receipt of money or other property solely because an amount owed by the seller to the taxpayer is netted against the purchase price of the property and the QI transfers to the taxpayer funds in an amount equal to the amount owed by the seller to the taxpayer so that the QI expends the full amount of the purchase price obligation for the replacement property.

Taxpayer owns multiple property that it leases to others. It has entered into a LKE program, set up under the safe-harbor rules of Revenue Procedure 2003-39, 2003-1 CB 971, and has entered into an MEA with a QI.

To finance property purchases, Taxpayer enters into Loan Security Arrangements (LSAs) where each loan is secured by a pool of separately identified properties as well as each property's associated lease contract and related lease and residual income stream. Under a unique titling arrangement, a trust holds title to all of Taxpayer's properties. Taxpayer is grantor and sole beneficiary of Trust, as well as initial beneficiary of certain special units of beneficial interest (SUBI), representing tax ownership of properties as an undivided trust interest in each property, the related leases, and the associated cash flows. Under the lending arrangements, Taxpayer transfers its beneficial interest in the SUBI, rather than actual title to each property, to a collateral trustee as collateral for its loans.

Collections of cash proceeds from the sale of relinquished properties will be deposited directly into a Joint Collection Account (JCA), where they will be under the QI's control, consistent with section 5.02 of Revenue Procedure 2003-39, 2003-1 CB 971. Any proceeds from the sale of collateral, including the sale of relinquished properties securing the loans, must be used to repay the loans.

Loans are structured to facilitate turnover in the pool of properties securing the loans while at the same time maintaining the net overall level of borrowing. If Taxpayer is required to apply property disposition proceeds to repay the LSA, it typically reborrows amounts from the LSA to fund new property purchases, which then replace disposed properties as collateral for the LSA. Under the

MEA, Taxpayer disposes of leased properties subject to the loans, and the proceeds from the dispositions are deposited directly with QI.

To the extent properties disposed of secure loans and to the extent loan terms require it, the MEA requires that QI repay the respective loans directly out of the JCA or by directing that payment be made directly to a "collateral agent." Taxpayer represents that it and QI intend to treat exchange proceeds received by QI from relinquished property subject to liabilities as relief of liabilities to be offset against consideration given by the exchanger in the form of cash or replacement property debt as provided in Regulation §1.1031(b)-1(c).

Under the MEA and the LSA, a transfer of old properties to third party buyers and the requirement to repay the loans are interdependent. In other words, a property cannot be transferred to a buyer without QI making a debt repayment equal to the lesser of any outstanding balances on the loan or the amount of relinquished property proceeds received by QI for such transfer. When Taxpayer wants to buy new properties, it deposits cash obtained either from new loan borrowings or other sources with QI to fund QI's acquisition of new properties. These new properties may be matched by Taxpayer for purposes of completing an exchange of old and new properties. Any new properties bought by QI with borrowed funds become security for the loans and are then subject to the same disposition and loan repayment requirements.

The PLR concludes that for purposes of Regulation §1.1031(k)-1, Taxpayer will not be in actual or constructive receipt of relinquished property proceeds where, under the terms of the MEA and the LSA, QI must use such the property proceeds to repay loans secured by the relinquished property.

Under the LSA, repayment of loans with relinquished property proceeds is required and the relinquished properties secure repayment of the loans. The full value of Taxpayer's properties secures repayment of the loans, and the lending agreement requires that any proceeds generated from the disposition of the relinquished properties securing the loans must be deposited directly with QI or are directed by QI to pay the loans and therefore must be used to repay any outstanding balances. As a result of QI acting as a conduit of the purchaser of the relinquished property in receiving the cash proceeds from the disposition, and using the proceeds to repay the outstanding liability on the relinquished property, which is interdependent and related to the transfer of the relinquished property to the buyer, IRS concluded that Taxpayer does not have actual or constructive receipt of the relinquished property proceeds for purposes of §1031.

The PLR further concludes that QI's repayment of relinquished property debt with relinquished property proceeds will be treated as liability relief for purposes of the boot netting rules of Regulation §1.1031(b)-1(c).

IRS reasoned that the Barker case supported a holding that: a) the proceeds from the disposition of the relinquished property in a deferred exchange of property can be used to pay off the relinquished property debt and b) the debt repayment will be treated as an assumption of debt by the buyer of the relinquished property for purposes of the boot netting rules under Regulation §1.1031(b)-1(c) even if there was no actual assumption of debt on the relinquished property by the buyer or transfer of the relinquished property to the buyer. Barker concluded that the boot netting principle in the regulations covers not just assumptions of debt but also situations in which the proceeds of the relinquished property are used to pay off debt secured by the relinquished property.

Legal Advice Issued by Field Attorneys 20172901F.

A taxpayer that took out a series of loans in Year 1, then in Year 2 refinanced several of the loans and repaid the remaining loans, was able to deduct in Year 2 the full amount of the previously unamortized debt issuance costs on the original loans.

Regulation §1.1001-3 determines whether a modification of the terms of a debt instrument results in an exchange for purposes of Regulation §1.1001-1(a). "For purposes of... Regulation §1.1001-1(a), a significant modification of a debt instrument...results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent." (Regulation §1.1001-3(b)) Regulation §1.1001-3(e)(2) through Regulation §1.1001-3(e)(6) provide specific rules for determining the significance of certain types of modifications.

Regulation §1.446-5 provides rules for allocating debt issuance costs over the term of the debt. Under Regulation §1.446-5(b)(1), "solely for purposes of determining the amount of debt issuance costs that may be deducted in any period, these costs are treated as if they adjusted the yield on the debt. To effect this, the issuer treats the costs as if they decreased the issue price of the debt....Thus, debt issuance costs increase or create original issue discount [("OID")] and decrease or eliminate bond issuance premium." Regulation §1.446-5(b)(2) requires an issuer of debt with debt issuance costs treated as OID to follow the rules under Regulation §1.163-7 to compute how much of that OID is deductible for a period.

Under Regulation §1.163-7(c), if a debt instrument is repurchased by the issuer for a price in excess of its adjusted issue price, the excess (repurchase premium) is deductible as interest for the tax year in which the repurchase occurs. If the issuer repurchases a debt instrument in a debt-for-debt exchange, the repurchase price is the issue price of the newly issued debt instrument (reduced by any unstated interest). However, if the issue price of the newly issued debt instrument is determined under either §1273(b)(4) or §1274, any repurchase premium is not deductible in the year of the repurchase, but is amortized over the term of the newly issued debt instrument in the same manner as if it were OID.

Regulation §1.1273-2(a) provides rules to determine the issue price of a debt instrument in an issue, including a debt instrument issued as a result of a significant modification under Regulation §1.1001-3. If a substantial amount of the debt instruments in an issue is issued for money, Regulation §1.1273-2(a)(1) provides "the issue price of each debt instrument in the issue is the first price at which a substantial amount of the debt instruments is sold for money."

The taxpayer entered into a series of loans in Year 1. In Year 2, it refinanced some of the loans, paid off the principal for the loans that it did not refinance, and also engaged in new borrowing.

The taxpayer and IRS agreed that the change in terms from the original loans to the refinanced loans and new loans created a change in yield that constituted a significant modification under Regulation §1.1001-3(e)(2).

The percentage of the refinanced loans and new loans that were issued for money was approximately 51%.

Whether the taxpayer is entitled to deduct the unamortized debt issuance costs of its debt upon the exchange of the debt for new debt.

IRS held that the amortized debt issuance costs were fully deductible in Year 2.

The taxpayer and IRS agreed that the change in yield from the original loans to the refinanced loans constitutes a significant modification under Regulation §1.1001-3(e)(2). Therefore, under Regulation §1.1001-3(b), the significant modification resulted in an exchange of the original loans for the newly issued loans.

Because the portion of the new loans that were issued for money was approximately 51%, a substantial amount of those loans was issued for money, and the issue price of each new loan was the first price at which a substantial amount of the new loans was issued for money. (Regulation §1.1273-2(a)(1)) As a result, the issue price of the new loans was not determined under either §1273(b)(4) or §1274.

Thus, in accordance with the rules in Regulation §1.163-7(c), the unamortized debt issuance costs allocable to the original loans repurchased for money would be deductible in the year of repurchase. In addition, the unamortized debt issuance costs allocable to the original loans repurchased in the debt-for-debt exchange would be deductible in the year of the exchange as well.

Legal Advice Issued by Associate Chief Counsel 2017-002.

IRS has determined that an accrual method taxpayer's costs of redeeming points in its "hybrid coupon" customer rewards program could not be accounted for under the Regulation §1.451-4 rules applicable to "premium" coupons. IRS reasoned that hybrid coupons, which may be redeemed for either products or used as a discount on a product purchase, are not premium coupons, which are exchanged for a certain product, and thus cannot be treated as such for deduction purposes.

In general, accrual-method taxpayers cannot claim deductions until a 3-part test is met. One of those parts is the all-events test-i.e., a deduction is not available until the tax year in which all the events have occurred that establish the fact of the liability. (Regulation §1.461-1(a)(2)(i)) This rule prohibits the deduction of estimated future costs.

However, there is an exception to this rule when a taxpayer issues "premium coupons" (defined below) or trading stamps with sales, where the coupons are redeemable by such taxpayer in merchandise, cash, or other property. (Regulation §1.451-4(a)(1)) Under the exception, the taxpayer, in computing the income from such sales, subtracts from gross receipts with respect to sales with which coupons or stamps are issued an amount equal to: (i) the cost to the taxpayer of the merchandise, cash, and other property used for redemptions in the tax year; (ii) plus the net addition to (or less the net subtraction from) the provision for future redemptions during the tax year.

A premium coupon, as explained by the Joint Committee on Taxation, is one that is issued in connection with the sale of some item and entitles the holder to tender it (or a number of premium coupons) in exchange for a product, often selected from a catalog, of the customer's choosing, in order to promote the sale of the product with which the coupon is issued.

In Revenue Ruling 78-212, 1978-1 CB 139, IRS ruled that Regulation §1.451-4 did not apply to "discount coupon" expenses (i.e., expenses associated with coupons that provide discounts on the sales price of certain products purchased in the future), reasoning that the right of redemption must be unconditional, with nothing further required from the consumer. (*Mooney Aircraft, Inc. v. U.S.,* (CA 5 1970) 420 F2d 400) IRS indicated in that ruling that the intent of Regulation §1.461-4 is to match, in the same tax year, revenues with the expenses incurred in producing those revenues. Implicit to this "matching concept" is that the issuance of a coupon with the sale of a product creates an incidental obligation in an accrual method taxpayer that requires the taxpayer to incur additional expenses at some future time, which is the case for premium coupons but not for discount coupons.

Taxpayer uses the accrual method and has a points-based loyalty rewards program designed to enhance its sales. Membership is free of charge and no purchase is necessary to join.

Under the rewards program, members earn points in connection with the purchase of qualifying products and services from retail stores or online portals at the time the purchase occurs. Members earn one point for every $1 spent on qualifying purchases. Each point has the value of 1¢ but points cannot be redeemed for cash. Points expire five years after the date earned. Accumulated points can be redeemed towards the purchase of products, which, depending on the number of points redeemed, can either be free or discounted.

Under its current accounting method, taxpayer deducts the cost of points in the year a point is redeemed by its members. Taxpayer proposes to instead subtract, from gross receipts for sales in the tax year in which points are issued, an amount equal to: (i) the cost to the taxpayer of merchandise, cash, and other property used for redemptions in the tax year; (ii) plus or minus the net addition/subtraction for the provision of future redemptions during the tax year.

The memo addresses whether these "hybrid" coupons-i.e., points that can be redeemed either for products or used as a discount on a purchase of a product-can be treated as "premium coupons" under Regulation §1.451-4.

The memo ruled that Regulation §1.451-4 is reserved solely for premium coupons and trading stamps. Hybrid coupons, like the points reward system used by Taxpayer, are not premium coupons and thus cannot be treated as such for Regulation §1.451-4 purposes.

Premium coupons, the memo noted, are generally coupons that are exchanged for a single product. A customer who does not have enough premium coupons to acquire a certain product must make additional purchases to collect more coupons until the customer can obtain the product-which ensures that the coupons are used to promote the sale of the product with respect to which the coupon is issued. Hybrid coupons, on the other hand, promote not just the sales of the products with which they are issued but also products bought in the future at a discount. The memo further noted that a customer could potentially acquire enough hybrid coupons to bring the price of an item to zero-similar to the effect of accumulating sufficient discount coupons-which makes hybrid coupons more closely aligned with discount coupons than with premium coupons in that the nature of both is a price reduction.

IRS Disaster Relief Updated to October 16, 2017

IRS has announced on its website that victims of the wildfires in counties of California, in addition to more Hurricane Harvey victims in counties of Texas, that are designated as federal disaster areas qualifying for individual assistance, have more time to make tax payments and file returns. Certain other time-sensitive acts also are postponed.

Who gets relief. Only taxpayers considered to be affected taxpayers are eligible for the postponement of time to file returns, pay taxes and perform other time-sensitive acts. Affected taxpayers are those listed in Regulation §301.7508A-1(d)(1) and thus include:

1. Any individual whose principal residence, and any business entity whose principal place of business, is located in the counties designated as disaster areas;

2. Any individual who is a relief worker assisting in a covered disaster area, regardless of whether he is affiliated with recognized government or philanthropic organizations;

3. Any individual whose principal residence, and any business entity whose principal place of business, is not located in a covered disaster area, but whose records necessary to meet a filing or payment deadline are maintained in a covered disaster area;

4. Any estate or trust that has tax records necessary to meet a filing or payment deadline in a covered disaster area; and

5. Any spouse of an affected taxpayer, solely with regard to a joint return of the husband and wife.

What may be postponed. Under §7508A, IRS gives affected taxpayers until the extended date (specified by county, below) to file most tax returns (including individual, estate, trust, partnership, C corporation, and S corporation income tax returns; estate, gift, and generation-skipping transfer tax returns; and employment and certain excise tax returns), or to make tax payments, including estimated tax payments, that have either an original or extended due date falling on or after the onset date of the disaster (specified by county, below), and on or before the extended date.

IRS also gives affected taxpayers until the extended date to perform other time-sensitive actions described in Regulation §301.7508A-1(c)(1) and Rev Proc 2007-56, 2007-34 IRB 388, that are due to be performed on or after the onset date of the disaster, and on or before the extended date. This relief also includes the filing of Form 5500 series returns, in the way described in Rev Proc 2007-56, Sec. 8. Additionally, the relief described in Rev Proc 2007-56, Sec. 17, relating to like-kind exchanges of property, also applies to certain taxpayers who are not otherwise affected taxpayers and may include acts required to be performed before or after the period above.

The postponement of time to file and pay does not apply to information returns in the W-2, 1098, 1099 or 5498 series, or to Forms 1042-S or 8027. Penalties for failure to timely file information returns can be waived under existing procedures for reasonable cause. Likewise, the postponement does not apply to employment and excise tax deposits. IRS, however, will abate penalties for failure to make timely employment and excise deposits, due on or after the onset date of the disaster, and on or before the deposit delayed date (specified by county, below), provided the taxpayer made these deposits by the deposit delayed date.

Affected areas and dates for storms, floods and other disasters occurring in 2017 that are federal disaster areas qualifying for individual assistance, as published on IRS's website.

Observation: Effective for disasters declared in tax years beginning after December 31, 2007, the term “federally declared disaster” replaced the previously used “presidential disaster area” term (see §1033(h)(3), as amended by Sec. 706(d)(1), Div. C, P.L. 110-343). The new term is substantially the same as the definition of “presidentially declared disaster” under former law. (T.D. 9443, 01/4/2009)

Arkansas: The following are federal disaster areas qualifying for individual assistance on account of severe storms, tornadoes, straight-line winds and flooding that took place beginning on April 26, 2017: Benton, Boone, Carroll, Clay, Faulkner, Fulton, Jackson, Lawrence, Pulaski, Randolph, Prairie, Saline, White, Woodruff, Washington, and Yell counties.

For these Arkansas counties, the onset date of the disaster was April 26, 2017 and the extended date was August 31, 2017 (which includes the estimated tax payment due on June 15, 2017 and the quarterly payroll tax returns due on May 1, 2017 and July 31, 2017). The deposit delayed date was May 11, 2017.

California: The following are federal disaster areas qualifying for individual assistance on account of wildfires that took place beginning on October 8, 2017: Butte, Lake, Mendocino, Napa, Nevada, Sonoma, and Yuba counties.

For these California counties, the onset date of the disaster was October 8, 2017 and the extended date is January 31, 2018 (which includes 2016 income tax returns for which taxpayers obtained a valid extension to file by October 16, 2017; the quarterly estimated income tax payments originally due on January 16, 2018; the quarterly payroll and excise tax returns normally due on October 31, 2017; and returns of tax-exempt organizations that operate on a calendar-year basis and had an automatic extension due to run out on November 15, 2017). The deposit delayed date is October 23, 2017. (IR 2017-172)

Florida: Following the President's declaration that a major disaster exists in the state of Florida, IRS has announced that affected taxpayers in the Seminole Tribe of Florida and associated lands, in addition to all 67 counties of Florida, will receive tax relief on account of Hurricane Irma, which took place beginning on September 4, 2017.

For these Florida counties, the onset date of the disaster was September 4, 2017 and the extended date is January 31, 2018 (which includes 2016 income tax returns for which taxpayers obtained a valid extension to file by October 16, 2017; the quarterly estimated income tax payments originally due on September 15, 2017 and January 16, 2018; the quarterly payroll and excise tax returns normally due on October 31, 2017; and returns of tax-exempt organizations that operate on a calendar-year basis and had an automatic extension due to run out on November 15, 2017). The deposit delayed date was September 19, 2017.

Georgia: The following is a federal disaster area qualifying for individual assistance on account of severe storms, tornadoes, and straight-line winds that took place beginning on January 2, 2017: Dougherty County.

For this Georgia County, the onset date of the disaster was January 2, 2017 and the extended date was May 31, 2017 (which includes 2016 income tax returns normally due on April 18, and the January 15 and April 18 deadlines for making quarterly estimated tax payments). The deposit delayed date was January 17, 2017.

Georgia: The following are federal disaster areas qualifying for individual assistance on account of severe storms, tornadoes, and straight-line winds that took place beginning on January 21, 2017: Berrien, Cook, Crisp, Dougherty, Thomas, Turner, Worth, and Wilcox counties.

For these Georgia counties, the onset date of the disaster was January 21, 2017 and the extended date was May 31, 2017 (which includes 2016 income tax returns normally due on April 18 and the April 18 deadlines for making quarterly estimated tax payments). The deposit delayed date was February 6, 2017.

Georgia: Following the President's declaration that a major disaster exists in the state of Georgia, IRS announced that affected taxpayers in the entire state (all 159 counties) will receive tax relief on account of Hurricane Irma, which took place beginning on September 7, 2017.

For the entire state of Georgia, the onset date of the disaster was September 7, 2017 and the extended date is January 31, 2018 (which includes 2016 income tax returns for which taxpayers obtained a valid extension to file by October 16, 2017; the quarterly estimated income tax payments originally due on September 15, 2017 and January 16, 2018; and the quarterly payroll and excise tax returns normally due on October 31, 2017; and the tax-exempt organizations that operate on a calendar-year basis and had an automatic extension due to run out on November 15, 2017). The deposit delayed date was September 22, 2017. (IR 2017-156)

Louisiana: The following are federal disaster areas qualifying for individual assistance on account of severe storms, tornadoes, and straight-line winds that took place beginning on February 7, 2017: Livingston and Orleans parishes.

For these Louisiana parishes, the onset date of the disaster was February 7, 2017, and the extended date was June 30, 2017 (which includes the 2016 income tax returns normally due on April 18 and the April 18 deadlines for making quarterly estimated tax payments). The deposit delayed date was February 22, 2017.

Michigan: The following are federal disaster areas qualifying for individual assistance on account of severe storms and flooding that took place beginning on June 22, 2017: Bay, Gladwin, Isabella, and Midland counties, and the Saginaw Chippewa Tribe within Isabella County.

For these Michigan counties, the onset date of the disaster was June 22, 2017, and the extended date is October 31, 2017 (which includes the 2016 income tax returns for which taxpayers obtained a valid extension to file by October 16, 2017; the September 15, 2017 deadline for making quarterly estimated tax payments; and the quarterly payroll tax return due on July 31, 2017). The deposit delayed date was July 7, 2017.

Mississippi: The following are federal disaster areas qualifying for individual assistance on account of severe storms, tornadoes, and straight-line winds that took place beginning on January 20, 2017: Forrest, Lamar, Lauderdale, and Perry counties.

For these Mississippi counties, the onset date of the disaster was January 20, 2017, and the extended date was May 31, 2017 (which includes the 2016 income tax returns normally due on April 18; the April 18 deadlines for making quarterly estimated tax payments; and the estimated income tax payment originally due on or after January 20, 2017, and before May 31, 2017). The deposit delayed date was February 6, 2017.

Missouri: The following are federal disaster areas qualifying for individual assistance on account of severe storms, tornadoes, straight-line winds, and flooding that took place beginning on April 28, 2017: Bollinger, Butler, Carter, Christian, Crawford, Dent, Douglas, Dunklin, Franklin, Gasconade, Greene, Howell, Jasper, Jefferson, Madison, Maries, McDonald, Newton, Oregon, Osage, Ozark, Pemiscot, Phelps, Pulaski, Reynolds, Ripley, Shannon, St. Louis, Ste. Genevieve, Stone, Taney, Texas, Wayne, and Wright counties.

For these Missouri counties, the onset date of the disaster was April 28, 2017, and the extended date was August 31, 2017 (which includes the estimated tax payment due on June 15, 2017 and the quarterly payroll tax returns due on April 30, 2017 and July 31, 2017). The deposit delayed date was May 15, 2017.

Puerto Rico: The following are federal disaster areas qualifying for individual assistance on account of Hurricane Irma that took place beginning on September 5, 2017: Adjuntas, Aguas Buenas, Barranquitas, Bayamón, Camuy, Carolina, Cataño, Ciales, Comerío, Culebra Canóvanas, Dorado, Fajardo, Guaynabo, Gurabo, Hatillo, Jayuya, Juncos, Las Piedras, Loíza Luquillo, Naguabo, Orocovis, Patillas, Quebradillas, Salinas, San Juan, Toa Baja, Utuado, Vega Baja, Vieques, and Yauco municipalities.

For these Puerto Rico municipalities, the onset date of the disaster was September 5, 2017, and the extended date is January 31, 2018 (which includes 2016 income tax returns for which taxpayers obtained a valid extension to file by October 16, 2017; the quarterly estimated income tax payments originally due on September 15, 2017 and January 16, 2018; the quarterly payroll and excise tax returns normally due on October 31, 2017; and returns of tax-exempt organizations that operate on a calendar-year basis and had an automatic extension due to run out on November 15, 2017).

For these Puerto Rico municipalities, the deposit delayed date was originally September 20, 2017. However, because these same areas were struck by Hurricane Maria less than two weeks later, the deposit delayed date was effectively extended to October 2, 2017.

Puerto Rico: Following the President's declaration that a major disaster exists in the Commonwealth of Puerto Rico, IRS announced that affected taxpayers in Puerto Rico (all 78 municipalities) will receive tax relief on account of Hurricane Maria, which took place beginning on September 17, 2017.

For these Puerto Rico municipalities, the onset date of the disaster was September 17, 2017, and the extended date is January 31, 2018 (which includes 2016 income tax returns for which taxpayers obtained a valid extension to file by October 16, 2017; the quarterly estimated income tax payment originally due on January 16, 2018; the quarterly payroll and excise tax returns normally due on October 31, 2017; and returns of tax-exempt organizations that operate on a calendar-year basis and had an automatic extension due to run out on November 15, 2017). The deposit delayed date was October 2, 2017.

Texas: The following are federal disaster areas qualifying for individual assistance on account of Hurricane Harvey that took place beginning on August 23, 2017: Aransas, Austin, Bastrop, Bee, Bexar, Brazoria, Burleson, Caldwell, Calhoun, Chambers, Colorado, Comal, Dallas, De Witt, Fayette, Fort Bend, Galveston, Goliad, Gonzales, Grimes, Guadalupe, Hardin, Harris, Jackson, Jasper, Jefferson, Jim Wells, Karnes, Kleberg, Lavaca, Lee, Liberty, Madison, Matagorda, Milam, Montgomery, Newton, Nueces, Orange, Polk, Refugio, Sabine, San Augustine, San Jacinto, San Patricio, Tarrant, Travis, Tyler, Victoria, Walker, Waller, Washington, and Wharton counties.

For these Texas counties, the onset date of the disaster was August 23, 2017, and the extended date is January 31, 2018 (including the September 15, 2017 and January 16, 2018 deadlines for making quarterly estimated tax payments, 2016 individual income tax returns for which taxpayers received a tax-filing extension until October 16, 2017, the October 31, 2017 deadline for quarterly payroll and excise tax returns, and returns of tax-exempt organizations with an original or extended filing deadline falling within the period beginning on August 23, 2017, and ending on January 31, 2018). The deposit delayed date was September 7, 2017.

U.S. Virgin Islands: The following are federal disaster areas qualifying for individual assistance on account of Hurricane Irma that took place beginning on September 5, 2017: St. Croix, St. John, and St. Thomas islands.

For these islands of the U.S. Virgin Islands, the onset date of the disaster was September 5, 2017, and the extended date is January 31, 2018 (which includes 2016 income tax returns for which taxpayers obtained a valid extension to file by October 16, 2017; the quarterly estimated income tax payments originally due on September 15, 2017 and January 16, 2018; the quarterly payroll and excise tax returns normally due on October 31, 2017; and returns of tax-exempt organizations that operate on a calendar-year basis and had an automatic extension due to run out on November 15, 2017).

For these islands of the U.S. Virgin Islands, the deposit delayed date was originally September 20, 2017. However, because these same areas were struck by Hurricane Maria less than two weeks later, the deposit delayed date was effectively extended to October 2, 2017.

U.S. Virgin Islands: The following are federal disaster areas qualifying for individual assistance on account of Hurricane Maria that took place beginning on September 16, 2017: St. Croix, St. John, and St. Thomas islands.

For these islands of the U.S. Virgin Islands, the onset date of the disaster was September 16, 2017, and the extended date is January 31, 2018 (which includes 2016 income tax returns for which taxpayers obtained a valid extension to file by October 16, 2017; the quarterly estimated income tax payment originally due on January 16, 2018; the quarterly payroll and excise tax returns normally due on October 31, 2017; and returns of tax-exempt organizations that operate on a calendar-year basis and had an automatic extension due to run out on November 15, 2017). The deposit delayed date was October 2, 2017.

West Virginia: The following are federal disaster areas qualifying for individual assistance on account of severe storms, flooding, landslides, and mudslides that took place beginning on July 28, 2017: Harrison, Marion, Marshall, and Wetzel counties.

For these West Virginia counties, the onset date of the disaster was July 28, 2017, and the extended date is November 30, 2017 (which includes 2016 income tax returns for which taxpayers obtained a valid extension to file by October 16, 2017; the September 15, 2017 deadline for making quarterly estimated tax payments; and the quarterly payroll and excise tax returns normally due on July 31, 2017 and October 31, 2017). The deposit delayed date was August 14, 2017.

Notice 2017-58, 2017-42 IRB

IRS has extended the due date for hurricane-affected participants filing disclosures under Notice 2017-10 (relating to syndicated conservation easement transactions) and Regulation §1.6011-4(e)(2)(i) (relating to subsequently listed transactions) from October 2, 2017 to October 31, 2017.

Under §6011 and its regulations, taxpayers must disclose their participation in reportable, tax-shelter-type transactions by, among other things, attaching an information statement to their income tax returns. Under §6111 , material advisors must disclose reportable transactions (e.g., identify and describe them and the claimed tax benefits), and under §6112 , material advisors must prepare and maintain lists for reportable transactions. Regs provide that reportable transactions include several categories of transactions including listed transactions and transactions of interest. (Regulation §1.6011-4(b)(1))

A listed transaction is a transaction that is the same as or substantially similar to one of the types of transactions that IRS has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction. (Regulation §1.6011-4(b)(2))

Penalties apply for participants who fail to disclose (§6707A), material advisors who fail to disclose (§6707), and material advisors who don't properly maintain or provide the required lists. (§6708)

Late in 2016, IRS released Notice 2017-10, 2017-4 IRB 544, in which it identified "syndicated conservation easement transactions" and substantially similar transactions as "listed transactions" for purposes of Regulation §1.6011-4(b)(2) , §6111 , and §6112 .

Notice 2017-10, Sec. 2 described such transactions as ones where:

1. An investor receives promotional materials that offer prospective investors in a pass-through entity the possibility of a charitable contribution deduction that equals or exceeds an amount that is two and one-half times the amount of the investor's investment. The promotional materials may be oral or written.

2. The investor purchases an interest, directly or indirectly (through one or more tiers of pass-through entities), in a pass-through entity that holds real property.

3. The pass-through entity that holds the real property contributes a conservation easement encumbering the property to a tax-exempt entity and allocates, directly or through one or more tiers of pass-through entities, a charitable contribution deduction to the investor.

4. Following that contribution, the investor reports on his or her federal income tax return a charitable contribution deduction with respect to the conservation easement.

In the case of a participant with a disclosure obligation with respect to a syndicated conservation easement transaction, under Regulation §1.6011-4(e)(2)(i) (regarding subsequently listed transactions), the disclosure was to be due to IRS's Office of Tax Shelter Analysis on June 21, 2017. In

Notice 2017-29, 2017-20 IRB 1243, IRS extended the due date in Notice 2017-10 for participants filing disclosures under Regulation §1.6011-4(e)(2)(i) from June 21, 2017, until October 2, 2017.

Extended deadline for those affected by recent hurricanes. In response to Hurricane Harvey, Hurricane Irma, and Hurricane Maria, Notice 2017-58 further extends the due date for affected participants (defined below) to file disclosures under §1.6011-4(e)(2)(i) from October 2, 2017, until October 31, 2017.

An affected participant is any participant whose principal residence or principal place of business was located in a Hurricane Harvey, Hurricane Irma, or Hurricane Maria covered disaster area, as defined in Regulation §301.7508A-1(d)(2) , or whose records necessary to meet the disclosure obligation were maintained in such a covered disaster area. Under Regulation §301.7508A-1(d)(2) , a "covered disaster area" is defined as a federally declared disaster area (within the meaning of §1033(h)(3)) to which IRS determines the extension of time to perform the acts specified in Regulation §301.7508A-1(b) applies.

In Notice 2017-58 , IRS advises that taxpayers who believe they are entitled to this extended due date should mark "Hurricane Harvey," "Hurricane Irma," or "Hurricane Maria" on the top of their Form 8886 (Reportable Transaction Disclosure Statement).

Notice 2017-29, 2017-10 IRB.

IRS has extended the due date for participants filing disclosures under Notice 2017-10 (relating to syndicated conservation easement transactions) and clarifies that, for purposes of Notice 2017-10, a donee described in §170(c) is not a material advisor.

Late in 2016, IRS released Notice 2017-10, 2017-4 IRB 544, in which it identified "syndicated conservation easement transactions" (described in Notice 2017-10, §2) and substantially similar transactions as "listed transactions" for purposes of Regulation §1.6011-4(b)(2), §6111, and §6112. In the case of a participant with a disclosure obligation with respect to these transactions under Regulation §1.6011-4(e)(2)(i) (regarding subsequently listed transactions), the disclosure was to be due to IRS's Office of Tax Shelter Analysis on June 21, 2017.

In Notice 2017-29, after receiving requests for additional time for participants to meet the disclosure obligation with respect to these transactions under Regulation §1.6011-4(e)(2)(i), IRS extended the due date for participants filing disclosures under Regulation §1.6011-4(e)(2)(i) from June 21, 2017, until October 2, 2017.

The due date for disclosure by material advisors under Regulation §301.6111-3(e) and participants who have disclosure obligations under Regulation §1.6011-4(e)(1) (regarding returns filed after December 23, 2016) with respect to the transaction described in Notice 2017-10, §2 is unchanged and remains May 1, 2017.

Notice 2017-10 also provided that, for purposes of Notice 2017-10, a donee described in §170(c) is not treated as a material advisor under §6111.

Notice 2017-17, 2017-15 IRB.

IRS issued and requested comments on a proposed Revenue Procedure that, if finalized, will set out how a taxpayer may request automatic consent to change a method of accounting for recognizing income when the change is made for the same tax year as the taxpayer adopts, and is a result of or directly related to the adoption of, the new financial accounting revenue recognition standards. Such a change is referred to throughout the Notice as a "qualifying same-year method change."

§446(a) and Regulation §1.446-1(a)(1) provide that taxable income is computed under the method of accounting the taxpayer regularly uses to compute income in keeping the taxpayer's books. Regulation §1.446-1(a)(4) requires a taxpayer to maintain accounting records that include the taxpayer's regular books of account and other records and data necessary to support the entries on the taxpayer's books of account and on the taxpayer's return. A taxpayer using an accrual method of accounting accrues income when the right to receive income is fixed and the amount can be determined with reasonable accuracy (the all events test). (Regulation §1.451-1(a))

In most cases, a taxpayer that wishes to change its method of accounting must apply for and secure the prior consent of IRS. (§446(e)) However, for some accounting method changes, IRS provides an automatic procedure for obtaining its consent to the change.

When a taxpayer changes its accounting method, §481(a) adjustments are generally required to be made to prevent items from being duplicated or omitted. (Regulation §1.446-1(e)(3)(i)) However, in limited circumstances, a "cut-off" method can be used instead, where only the items arising on or after the beginning of the year of change are accounted for under the new accounting method.

In January, 2015, IRS issued Revenue Procedure 2015-13, 2015-5 IRB 419, which updated and revised the procedures under which a taxpayer may obtain automatic consent for a change in an accounting method, and Revenue Procedure 2014-14, 2015-5 IRB 450, which contained a list of automatic changes to which the automatic change procedures apply. Both of those revenue procedures were updated thereafter. IRS most recently updated its list in Revenue Procedure 2016-29, 2016-21 IRB 880.

In a joint announcement on May 28, 2014, the FASB and the IASB announced new financial accounting standards for recognizing revenue titled "Revenue from Contracts with Customers" (new standards).

The new standards are effective for publicly-traded entities, certain not-for-profit entities, and certain employee benefit plans for annual reporting periods beginning after December 15, 2017. For all other entities, the new standards are effective for annual reporting periods beginning after December 15, 2018. Early adoption is allowed for reporting periods beginning after December 15, 2016.

On June 15, 2015, IRS published Notice 2015-40, 2015-24 IRB 1057, which requested comments on federal tax accounting issues related to the adoption of the new standards, including, whether the new standards are permissible methods of accounting for federal income tax purposes, the types of accounting method change requests that might result from adopting the new standards, and whether the current procedures for obtaining IRS consent to change a method of accounting are adequate to accommodate those requests. Very few comments were received.

Notice 2017-17 addresses only the procedures for obtaining IRS consent to a qualifying same-year method change. IRS explained that qualifying same-year method changes may include automatic changes for which existing guidance already provides automatic change procedures, in which case the existing automatic change procedures must be used. However, for qualifying same-year method changes for which existing guidance does not provide automatic change procedures but which comply with §451 or other guidance regarding the tax year of inclusion of income, the taxpayer must make the change under the proposed Revenue Procedure.

Adoption of the new standards may create or increase differences between financial accounting and tax accounting rules. The Treasury Department and IRS recognize that there is interest in clarifying whether the new standards are permissible methods of accounting that may be used for federal income tax purposes and seek comment on:

1. The extent to which using the new standards would result in acceleration or deferral of income under §451 or other Code provisions;

2. Industry and/or transaction-specific issues that may arise as a result of the new standards and that might be addressed in future guidance;

3. The extent to which the new standards deviate from the requirements of §451, and situations in which IRS should allow taxpayers who adopt the new standards to follow their book method of accounting for tax purposes; and

4. The extent to which the rules regarding allocation of standalone sales price and transaction price in the new standards affect taxpayers' ability to satisfy their tax obligations.

In addition, IRS requested comments on all aspects of the proposed procedures and on the specific method change issues identified in Notice 2015-40, including on:

1. Whether the exception for small businesses in §5.02(2) of the proposed revenue procedure(below) is appropriate**;**

2. Types of changes in methods of accounting taxpayers anticipate requesting;

3. Whether taxpayers anticipate requesting changes in methods of accounting prior to the effective dates of the new standards;

4. Whether taxpayers should be required to use the automatic consent accounting method change procedures or the advance consent procedures to request permission to change a method of accounting under the new standards, and why;

5. What changes, other than those described in Section 5 of the proposed revenue procedure, taxpayers expect will be requested in the year the taxpayer adopts the new financial standards, and whether they should be allowed as automatic changes;

6. What related accounting method changes taxpayers anticipate requesting that may appropriately be made on a single Form 3115, Application for Change in Accounting Method;

7. If multiple changes are requested on a single Form 3115, whether the taxpayer should report a separate §481 adjustment for each change and whether those adjustments should be netted and a single spread period applied;

8. Alternatives to filing a Form 3115 that would reduce compliance burdens;

9. Transition procedures that may be helpful; and

10. Additional procedural changes that would be appropriate and helpful.

IRS requested that comments be submitted by July 24, 2017.

The proposed Revenue Procedure would apply to taxpayers that adopt the new standards and that request IRS's consent to make a qualifying same-year method change, effective for tax years ending on or after its date of publication as final. (Proposed Rev Proc, Secs. 4, 6)

a. Changes covered by existing guidance. A qualifying same-year method change that qualifies as an automatic change in the List of Automatic Changes (under Revenue Procedure 2016-29, or any successor) and otherwise satisfies the eligibility requirements to request IRS consent to make a change in accounting method under the automatic change procedures in Revenue Procedure 2015-13, §5.01,(a)-(d)(or any successor), would be required to be implemented by applying the automatic change procedures in Revenue Procedure 2015-13, §6 (or any successor) and the List of Automatic Changes.(Proposed Rev Proc, §5.01)

b. Other changes. A qualifying same-year method change that is not described in Section 5.01, above, which satisfies the requirements of Revenue Procedure 2015-13, §5.01, (c) and (d) (or any successor), and which complies with §451 or other guidance, would be required to be implemented by applying the automatic change procedures in Revenue Procedure 2015-13, §6 (or any successor). A taxpayer making such a change would be required to file a Form 3115, check the box for line 1(b), and write "Revenue Procedure 2017-XX" followed by the applicable income provision of the Code or regulations or the applicable relevant guidance. In addition, the taxpayer would have to attach a brief description of the change and why it satisfies the applicable income provision or guidance referenced in line 1(b) of the Form 3115. (Proposed Rev Proc, §5.02(1))

c. Small business exception. A taxpayer with one or more separate and distinct trades or businesses, within the meaning of Regulation §1.446-1(d), that individually have(a) total assets of less than $10 million as of the first day of the tax year for which a change in method of accounting is requested, or (b) average annual gross receipts of $10 million or less for the three preceding tax years, as determined under Regulation §1.263(a)-3(h)(3)(substituting "separate and distinct trade or business" for "taxpayer"), would be able to make the change for each such separate and distinct trade or business on a cut-off basis. Accordingly, a §481(a) adjustment would neither be permitted nor required for each such separate and distinct trade or business. See Revenue Procedure 2015-13, §2.07. (Proposed Rev Proc, §5.02(2))

d. §481(a) adjustment. A §481(a) adjustment would be required to be computed for the year of change for all separate and distinct trades or businesses other than those for which §5.02(2), above, provides otherwise and for taxpayers for which §5.02(2) does not apply. See Revenue Procedure 2015-13, §7.02. (Proposed Rev Proc, §5.02(3))

e. Consolidated requests. Multiple requests to make qualifying same-year method changes would be permitted to be made in one request. (Proposed Rev Proc, §5.03)

Notice 2017-10, 2017-04 IRB.

IRS has determined that syndicated conservation easement transactions that provide investors in a pass-through entity the possibility of a charitable contribution deduction that equals or exceeds two and one-half times the amount of the investor's investment, and similar transactions, are listed transactions under rules that require disclosure of those transactions by participants and advisors.

Background-conservation easements. §170(f)(3)(B)(iii) allows a deduction for a qualified conservation contribution. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. (§170(h)(1) through §170(h)(5); Regulation §1.170A-14) A qualified real property interest includes a restriction, granted in perpetuity, on the use that may be made of real property. (§170(h)(2)(C)) For purposes of Notice 2017-10, a qualified real property interest is referred to as a conservation easement.

Under §6011 and its regulations, taxpayers must disclose their participation in reportable, tax-shelter-type transactions by, among other things, attaching an information statement to their income tax returns. Under §6111, material advisors must disclose reportable transactions (e.g., identify and describe them and the claimed tax benefits), and under §6112, material advisors must prepare and maintain lists for reportable transactions. Regulations provide that reportable transactions include several categories of transactions including listed transactions and transactions of interest. (Regulation §1.6011-4(b)(1))

A listed transaction is a transaction that is the same as or substantially similar to one of the types of transactions that IRS has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction. (Regulation §1.6011-4(b)(2))

Regulation §1.6011-4(e) and Regulation §301.6111-3(e) provide timing requirements for reporting tax shelter transactions by participants and advisers, respectively. If a transaction becomes a listed transaction after the filing of a taxpayer's tax return (including an amended return) reflecting the taxpayer's participation in either the listed transaction or transaction of interest, and before the end of the period of limitations for assessment of tax for any tax year in which the taxpayer participated in the transaction, then a disclosure statement must be filed, regardless of whether the taxpayer participated in the listed transaction or transaction of interest in the year the transaction became a listed transaction or transaction of interest, within 90 calendar days after the date on which the transaction became a listed transaction or transaction of interest. (Regulation §1.6011-4(e)(2))

Regulation §1.6011-4(c)(3)(i)(A) sets out whether a taxpayer has participated in a listed transaction.

Penalties exist for participants who fail to disclose (§6707A), material advisors who fail to disclose (§6707), and material advisors who do not properly maintain or provide the required lists (§6708), as described above.

Notice 2017-10, §2 set out the facts for the type of transaction that is a "listed transaction" for purposes of Regulation §1.6011-4(b)(2), §6111, and §6112:

a. An investor receives promotional materials that offer prospective investors in a pass-through entity the possibility of a charitable contribution deduction that equals or exceeds an amount that is two and one-half times the amount of the investor's investment. The promotional materials may be oral or written.

b. The investor purchases an interest, directly or indirectly (through one or more tiers of pass-through entities), in the pass-through entity that holds real property.

c. The pass-through entity that holds the real property contributes a conservation easement encumbering the property to a tax-exempt entity and allocates, directly or through one or more tiers of pass-through entities, a charitable contribution deduction to the investor.

d. Following that contribution, the investor reports on his or her federal income tax return a charitable contribution deduction with respect to the conservation easement.

IRS also set out the following additional illustration of these transactions covered by Notice 2017-10:

The promoters (i) identify a pass-through entity that owns real property, or (ii) form a pass-through entity to acquire real property. Additional tiers of pass-through entities may be formed. The promoters then syndicate ownership interests in the pass-through entity that owns the real property, or in one or more of the tiers of pass-through entities. The promoters obtain an appraisal that purports to be a qualified appraisal as defined in §170(f)(11)(E)(i) but that greatly inflates the value of the conservation easement based on unreasonable conclusions about the development potential of the real property.

After an investor invests in the pass-through entity, the pass-through entity donates a conservation easement encumbering the property to a tax-exempt entity. Investors who held their direct or indirect interests in the pass-through entity for one year or less may rely on the pass-through entity's holding period in the underlying real property to treat the donated conservation easement as long-term capital gain property under §170(e)(1). The promoter receives a fee or other consideration with respect to the promotion, which may be in the form of an interest in the pass-through entity.

IRS intends to challenge the purported tax benefits from this transaction based on the overvaluation of the conservation easement. IRS may also challenge the purported tax benefits from this transaction based on the partnership anti-abuse rule, economic substance, or other rules or doctrines.

Transactions entered into on or after January 1, 2010, that are the same as, or substantially similar to, the transaction described under "Facts for the type of transaction covered by Notice 2017-10," above, are listed transactions for purposes of Regulation §1.6011-4(b)(2), §6111 and §6112, effective December 23, 2016. Persons entering into these transactions on or after January 1, 2010 must disclose the transactions as described in Regulation §1.6011-4 for each tax year in which the taxpayer participated in the transactions, provided that the period of limitations for assessment of tax has not ended on or before December 23, 2016. Material advisors, including appraisers, who make a tax statement on or after January 1, 2010, with respect to transactions entered into on or after January 1, 2010, have disclosure and list maintenance obligations under §6111 and §6112.

For rules regarding the time for providing disclosure of a transaction described in Notice 2017-10, see Regulation §1.6011-4(e) and Regulation §301.6111-3(e). However, if, under Regulation §1.6011-4(e)(1), a taxpayer is required to file a disclosure statement with respect to a transaction described in Notice 2017-10 after December 23, 2016 and prior to May 1, 2017, that disclosure statement will be considered to be timely filed if the taxpayer alternatively files the disclosure by May 1 (April 30 is a Sunday). In addition, for purposes of disclosure of transactions described in Notice 2017-10, the 90-day period provided in Regulation §1.6011-4(e)(2)(i) is extended to 180 days. Further, if under Regulation §301.6111-3(e), a material advisor is required to file a disclosure statement with respect to the listed transaction described in Notice 2017-10 by January 31, 2017, that disclosure statement will be considered to be timely filed if the taxpayer files the disclosure by May 1, 2017 (April 30 is a Sunday).

Independent of their classification as listed transactions, transactions that are the same as, or substantially similar to, the syndicated conservation easement transaction described above may already be subject to the requirements of §6011, §6111, §6112, or the regulations thereunder.

Whether a taxpayer has participated in the listed transaction described above will be determined under Regulation §1.6011-4(c)(3)(i)(A). Participants include, but are not limited to, investors, the pass-through entity (any tier, if multiple tiers are involved in the transaction), or any other person whose tax return reflects tax consequences or a tax strategy described in Section 2. For purposes of

Notice 2017-10, a donee described in §170(c) will not be treated as a party to the transaction under §4965 (Excise tax on tax-exempt entities entering into prohibited transactions) or a participant under Regulation §1.6011-4.

Participants required to disclose these transactions under Regulation §1.6011-4 who fail to do so will be subject to penalties under §6707A. Participants required to disclose these transactions under Regulation §1.6011-4 who fail to do so may also be subject to an extended period of limitations under §6501(c)(10). Material advisors required to disclose these transactions under §6111 who fail to do so may be subject to the penalty under §6707. Material advisors required to maintain lists of investors under §6112 who fail to do so (or who fail to provide such lists when requested by IRS) may be subject to the penalty under §6708(a). In addition, IRS may impose other penalties on persons involved in these transactions or substantially similar transactions, including the accuracy-related penalty under §6662 or §6662A, the §6694 penalty for understatements of a taxpayer's liability by a tax return preparer, and the §6695A penalty for certain valuation misstatements attributable to incorrect appraisals.

IRS recognizes that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in Notice 2017-10. Those taxpayers should take appropriate corrective action and ensure that their transactions are disclosed properly.

Notice 2017-6, 2017-3 IRB.

IRS has extended the period during which a rule that precludes the use of automatic accounting method changes is waived, with respect to accounting method changes that are made to comply with the tangible property regulations that were promulgated in 2013 and 2014. As extended, the waiver applies for any tax year that begins before January 1, 2017.

In September 2013, IRS published final tangible property regulations (final tangible property regulations); in July 2014, it published corrections to those regulations. The final tangible property regulations provide guidance on the treatment of amounts paid to acquire, produce, or improve tangible personal property.

In August 2014, IRS published additional tangible property regulations (final depreciation and disposition regulations); in December 2014, it published corrections to those regulations. The final depreciation and disposition regulations provide guidance regarding accounting for property depreciated under §168, the Modified Accelerated Cost Recovery System (MACRS), and for dispositions of MACRS property.

Under §446(e), taxpayers must obtain IRS's consent before changing a method of accounting for federal income tax purposes. In most cases, a taxpayer that wishes to change its method of accounting must apply and secure the prior consent of IRS. For some accounting method changes, IRS provides an automatic procedure for obtaining its consent to the change. In general, a taxpayer uses Form 3115 (Application for Change in Accounting Method) for an accounting method change.

A taxpayer seeking to change its method of accounting under the above-described regulations must secure the consent of IRS in accordance with Regulation §1.446-1(e) and follow the administrative procedures issued under Regulation §1.446-1(e)(3)(ii).

Revenue Procedure 2015-13, 2015-5 IRB 419, provides the general procedures under §446(e) for a taxpayer to obtain the automatic or non-automatic consent of IRS to change a method of accounting. Revenue Procedure 2016-29, 2016-21 IRB 880, provides the list of automatic changes in methods of accounting to which the automatic change procedures of Revenue Procedure 2015-13 apply.

Revenue Procedure 2016-29 provides for certain automatic changes to utilize the final tangible property regulations and the final depreciation and disposition regulations.

Revenue Procedure 2015-13, §5.01(1)(f), provides that the automatic change procedures may not be utilized if the taxpayer has made or requested a change for the same item during any of the five tax years ending with the year of change. This rule generally precludes a taxpayer from using the automatic change procedures to change the treatment of the same item more than once within a 5-year period. However, in order to facilitate the transition to the final tangible property regulations and the final depreciation and disposition regulations, several sections of Revenue Procedure 2016-29 specifically provide that the eligibility rule in Revenue Procedure 2015-13, §5.01(1)(f), does not apply to a taxpayer that makes one or more of the changes in method of accounting permitted under that section for any tax year beginning before January 1, 2016.

Notice 2017-6 changes the January 1, 2016 date that is contained in the various sections of Revenue Procedure 2016-29 to January 1, 2017.

IRS is aware that taxpayers continue to request consent to change their methods of accounting to utilize the final tangible property regulations and final depreciation and disposition regulations. To continue to ease taxpayers' transition to these final regulations and to reduce the administrative burden that would result from requiring taxpayers to apply for non-automatic changes of accounting methods for each of the changes specified above, Notice 2017-6 extends the waiver.

If, before December 20, 2016, a taxpayer properly filed a Form 3115 under the non-automatic change procedures in Revenue Procedure 2015-13, that requested IRS's consent for a change in method of accounting described in Notice 2017-6, and the Form 3115 is pending with the IRS national office on December 20, 2016, the taxpayer may choose to make the change of accounting method under the automatic change procedures in Revenue Procedure 2015-13 by following the requirements and procedures in subsection.02(1) of the Effective Date section in Revenue Procedure 2016-29 with the following modifications:

1. The references to the date, "May 5, 2016," are replaced with the date, "December 20, 2016"; and

2. The references to the date, "June 6, 2016," are replaced with the date, "January 19, 2017."

For example, under the rules in subsection.02(1) of the Effective Date section in Revenue Procedure 2016-29, as modified by Notice 2017-6, if before December 20, 2016, a taxpayer properly filed a Form 3115 under the non-automatic change procedures in Revenue Procedure 2015-13, that requested IRS's consent for a change in method of accounting described in Revenue Procedure 2016-29, and the Form 3115 is pending with the national office on December 20, 2016, the taxpayer may choose to make the change in method of accounting under the automatic change procedures in Revenue Procedure 2015-13 if the taxpayer is otherwise eligible to use Revenue Procedure 2016-29 and the automatic change procedures in Revenue Procedure 2015-13. The taxpayer must notify the national office contact person for the Form 3115 of the taxpayer's intent to make the change in method of accounting under the automatic change procedures in Revenue Procedure 2015-13 before the later of (a) January 19, 2017, or (b) the issuance of a letter ruling granting or denying consent for the change.

Notice 2017-4, 2017-3 IRB.

IRS has clarified a recently issued Notice that provided guidance on the date by which facilities must begin construction to qualify for the §45 renewable electricity production tax credit (production tax credit) or the §48 energy investment tax credit (investment tax credit), as extended and modified under the Protecting American from Tax Hikes Act of 2015 (PATH, P.L. 114-113).

Under §45, a production tax credit for electricity produced from certain renewable resources is available for such electricity produced at a qualified facility during the 10-year period beginning on the date the facility was originally placed in service. The credit, i.e., the renewable electricity production credit, is allowed for electricity produced by taxpayers from: (1) wind, (2) closed-loop biomass, (3) open-loop biomass, (4) geothermal energy, (5) municipal solid waste, (6) marine and hydrokinetic renewables (e.g., waves and tides), (7) qualified hydropower production, (8) small irrigation power, and (9) solar power.

In addition, taxpayers can elect to have qualified property which is part of certain qualified facilities treated as energy property eligible for a 30% investment credit under §48. These facilities are wind facilities and the other §45(d) facilities (other than refined or Indian coal facilities or solar facilities) for which no §45 credit has been allowed.

Prior to the *American Taxpayer Relief Act of 2012* (ATRA, P.L. 112-240), former §45(d) required a facility to be placed in service before January 1, 2014 in order to be a qualified facility, except for qualified wind facilities which had to be placed in service before January 1, 2013. ATRA modified the definition of "certain qualified facilities" under §45(d) by replacing the placed in service requirement with a beginning of construction requirement. The date by which construction of a qualifying facility must begin was then extended for one year, to January 1, 2015, by the Tax Increase Prevention Act of 2014 (TIPA, P.L. 113-295).

The *Protecting American from Tax Hikes Act of 2015, Div. Q* (PATH Act, P.L. 114-113, 12/18/2015) extended the production tax credit for two years for certain facilities the construction of which begins before January 1, 2017 and for wind facilities the construction of which begins before January 1, 2020.

The PATH Act also modified the credit for wind facilities by providing that the credit will phase out over the next four years. Under §45(b)(5), as modified by the PATH Act, wind facilities the construction of which begins before January 1, 2017 are eligible to receive 100% of the production tax credit; wind facilities the construction of which begins after December 31, 2016 and before January 1, 2018 are eligible to receive 80% of the credit; wind facilities the construction of which begins after December 31, 2017 and before January 1, 2019 are eligible to receive 60% of the credit; and wind facilities the construction of which begins after December 31, 2018 and before January 1, 2020 are eligible to receive 40% of the credit.

In addition, the PATH Act extended the election to claim the investment tax credit in lieu of the production tax credit for certain renewable energy facilities if construction of the facility begins before January 1, 2017 (or January 1, 2020 in the case of wind facilities).

The PATH Act also extended and modified the investment tax credit for solar energy facilities the construction of which begins before January 1, 2022. Notice 2017-4 notes that IRS anticipates issuing separate guidance addressing the extension and modification of the investment tax credit for solar energy facilities.

five notices to clarify when construction has begun on a qualified facility: Notice 2013-29, 2013-20 IRB 1085; Notice 2013-60, 2013-2 CB 431; Notice 2014-46, 2014-36 IRB 520; Notice 2015-25, 2015-13 IRB 814; and Notice 2016-31, 2016-23 IRB 1025-collectively "the prior IRS Notices."

Notice 2017-4 updates and clarifies the guidance provided in the prior IRS Notices. As a result, IRS will not issue private letter rulings to taxpayers on the application of Notice 2017-4, the prior IRS Notices, or the beginning of construction requirement under §45(d) and §48(a)(5).

Notice 2013-60, §3.02, provides a Continuity Safe Harbor that allows a facility to be deemed to satisfy the Continuous Construction Test, as defined in Notice 2013-29, §4.06 (for purposes of satisfying the Physical Work Test provided in Notice 2013-29, §4), or the Continuous Efforts Test, as defined in Notice 2013-29, §5.02 (for purposes of satisfying the 5% Safe Harbor), based on the date on which a facility is placed in service. If a facility does not satisfy the Continuity Safe Harbor, whether the facility satisfies the Continuous Construction or Continuous Efforts Tests is determined by the relevant facts and circumstances. Notice 2016-31, §3, modifies and extends the Continuity Safe Harbor by providing that if a taxpayer places a facility in service by the later of (1) a calendar year that is no more than four calendar years after the calendar year during which construction of the facility began or (2) December 31, 2016, the facility will be considered to satisfy the Continuity Safe Harbor.

Notice 2017-4, §3, modifies the Continuity Safe Harbor provided in Notice 2016-31, §3, by providing that if a taxpayer places a facility in service by the later of (1) a calendar year that is no more than four calendar years after the calendar year during which construction of the facility began or (2) December 31, 2018, the facility will be considered to satisfy the Continuity Safe Harbor. For example, if construction begins on a facility on January 15, 2013, and the facility is placed in service by December 31, 2018, the facility will be considered to satisfy the Continuity Safe Harbor. Alternatively, if construction begins on a facility on January 15, 2016, and the facility is placed in service by December 31, 2020, the facility will be considered to satisfy the Continuity Safe Harbor.

Notice 2016-31, §4.01, provides that a taxpayer may not rely upon the Physical Work Test and the 5% Safe Harbor in alternating calendar years to satisfy the beginning of construction requirement or the Continuity Requirement. For example, if a taxpayer performs physical work of a significant nature on a facility in 2015, and then pays or incurs 5% or more of the total cost of the facility in 2016, the Continuity Safe Harbor will be applied beginning in 2015, not in 2016.

Notice 2017-4, §4, modifies Notice 2016-31, §4.01, by providing that this rule applies to facilities the construction of which begins after June 6, 2016 (the date on which Notice 2016-31 was published).

Notice 2016-31, §6.01, provides that a facility may qualify as originally placed in service even though it contains some used property, provided the fair market value of the used property is not more than 20% of the facility's total value (the cost of the new property plus the value of the used property) (the 80/20 Rule). Notice 2016-31, §6.02, provides that to satisfy the beginning of construction requirement for §45 and §48, the 5% Safe Harbor is applied only with respect to the cost of new property used to retrofit an existing facility. Accordingly, only expenditures paid or incurred that relate to new construction should be taken into account for purposes of the 5% Safe Harbor. Notice 2013-29, §5.01(1), provides that for purposes of the 5% Safe Harbor, all costs properly included in the depreciable basis of the facility are taken into account to determine whether the Safe Harbor has been met. The total cost of the facility does not include the cost of land or any property not integral to the facility, as described in Notice 2013-29, §4.05(1).

Notice 2017-4, §5, clarifies that for purposes of the 80/20 rule, the cost of new property includes all costs properly included in the depreciable basis of the new property.

Notice 2017-4 is applicable to any project for which a taxpayer claims the production tax credit or the investment tax credit, as modified by ATRA that is placed in service after January 2, 2013.

IRS Website, "A change to AMT adjustments for depreciation on Forms 6251, 4626, Sched I (Form 1041)" (January 19, 2017).

IRS has announced that it needs to amend the 2016 individual, corporation and fiduciary alternative minimum tax (AMT) form instructions to reflect a change made by the 2015 Protecting Americans from Tax Hikes (PATH) Act that resulted in certain property not being subject to an AMT adjustment for depreciation.

Section 143(b) of the *PATH Act* (P.L. 114-113, 12/18/2015) made several changes to the additional first-year depreciation deduction under §168(k). Prior to these changes, if a taxpayer elected not to take that depreciation allowance for qualified property, the property may have been subject to an AMT adjustment for depreciation. Under the change to §168(k), if the taxpayer elects not to take the depreciation allowance for qualified property, the property will not be subject to an AMT adjustment for depreciation if placed in service after 2015. (§168(k)(2)(G))

IRS has now announced that the above change impacts Instructions for Form 6251 (Alternative Minimum Tax - Individuals), Instructions for Form 4626 (Alternative Minimum Tax - Corporations), and Instructions to Schedule I (Form 1041) (Alternative Minimum Tax - Estates and Trusts), which will be updated shortly.

IR-2017-158

Long-anticipated examination guidance on the credit for increasing research activities under Section 41 (Research Credit) was released in a Directive dated September 11, 2017 (LB&I-04-0917-005). The stated purpose of the guidance is "to provide an efficient manner of determining qualified research expenses ('QREs') for LB&I taxpayers that meet the requirements of this Directive and to more efficiently manage LB&I's audit resources."

The Directive essentially describes a safe harbor methodology for determining a category of QREs that will not be challenged by the IRS. The Directive states that it "provides an administrative solution to accept as sufficient evidence of QREs the Adjusted ASC 730 Financial Statement R&D for the Credit Year."

The Directive applies to LB&I taxpayers that follow US GAAP for their certified audited financial statements. The certified audited financial statements must show "the amount of the currently expensed ASC 730 Financial Statement R&D" as a "separate line item on the income statement" or a "separately stated … note." The Directive only applies to original tax returns that are timely filed (including extensions) on or after September 11, 2017.

The amount of a taxpayer's QREs that will not be challenged for the credit year is the adjusted "ASC 730 Financial Statement R&D." The adjustments to the taxpayer's research and development costs currently expensed under ASC 730 include amounts related to foreign entities, Schedule M-3 amounts, amounts specifically excluded from Section 174, certain general ledger accounts, prototype overhead amounts, certain upper-level management wages and stock-based compensation. The adjustments to the ASC 730 Financial Statement R&D amount are both exclusions and inclusions, and such adjustments have defined terms in the Directive.

The Directive contains a certification statement to be executed by the taxpayer under penalties of perjury. Additionally, the taxpayer must agree to maintain and make available documentation that will support the amounts claimed as adjusted ASC 730 Financial Statement R&D. The certification statement and related appendices may be attached to the taxpayer's return to demonstrate eligibility under the Directive. If the taxpayer does not attach the certification statement and appendices, the IRS will request the documents upon examination.

For taxpayers with comprehensive and detailed books and records that apply ASC 730 for US GAAP purposes, the Directive may be an effective method of limiting the burden and examination risk related to a portion of their QREs. The Directive does not apply, however, to amounts not expensed for financial statement purposes, or expensed under other provisions.

II. INDIVIDUALS AND TRUSTS.

Acone, TC Memo 2017-162.

A commercial airline pilot failed both the "tax home" test and the "bona fide residence" test, despite the fact that he was stationed in South Korea, and that therefore he did not qualify for the foreign earned income exclusion.

§911(a) provides that a qualified individual may elect to exclude from gross income, subject to limitations set out in §911(b)(2), his or her foreign earned income. To be entitled to this exclusion, a taxpayer must satisfy several requirements.

One of those requirements is that he or she must be an individual "whose tax home is in a foreign country." (§911(d)(1)) §911(d)(3) provides that the term "tax home" means in the case of an individual, "such individual's home for purposes of §162(a)(2)." Under §162(a)(2), a person's home is generally considered to be the location of his or her regular or principal place of business. (*Mitchell,* (1980) 74 TC 578)

However, §911(d)(3) also provides that "[an] individual shall not be treated as having a tax home in a foreign country for any period for which his abode is within the U.S." That is, an individual whose "abode" is within the U.S. cannot establish that his or her "tax home" is in a foreign country. *(Jones,* (CA 5 1991) 67 AFTR 2d 91-795, *Harrington,* (1989) 93 TC 297)

Another of those requirements is that he must be either: (a) a U.S. citizen who is "a bona fide resident of a foreign country...for...an entire tax year" (§911(d)(1)(A)); or (b) a U.S. citizen or resident who is "present in a foreign country or countries during at least 330 full days" of a 12-month period. (§911(d)(1)(B))

The Sochurek standard (*Sochurek,* (CA 7 1962) 9 AFTR 2d 883) sets out the following factors for determining whether a taxpayer is a bona fide resident of a foreign country: (1) intention of the taxpayer; (2) establishment of the taxpayer's home temporarily in the foreign country for an indefinite period; (3) participation in the activities of the chosen community; (4) physical presence in the foreign country consistent with the taxpayer's employment; (5) nature, extent and reasons for temporary absences from the taxpayer's temporary foreign home; (6) assumption of economic burdens and payment of taxes to the foreign country; (7) status contrasted to that of transient or sojourner; (8) treatment of taxpayer's income tax status by his or her employer; (9) marital status and residence of taxpayer's family; (10) nature and duration of his employment; (11) good faith in making the trip abroad, e.g., whether for purpose of tax evasion.

The taxpayer, Mr. Acone, flew airplanes for a South Korean airline company, Korean Air Lines (KAL), in 2011 and 2012. KAL considered him to be "stationed" in Incheon, Korea, which meant that Incheon was the airport that Mr. Acone most frequently flew out of and flew into.

During the time he spent in South Korea, he played tennis and golf and participated in dinner engagements, largely with other airplane pilots. He took assorted lessons from individuals as well as KAL to learn various phrases in Korean as well as other things about South Korea.

But he spent only about a third of each year in South Korea and more than 40% of each year in the U.S. Acone returned to his home in the U.S. frequently during those years and spent most of his days off in the U.S., where his wife and house remained. The mean length of Mr. Acone's stays in the U.S. in 2011 was 7.95 days, while the mean length of his stays in South Korea that year was 2.45 days.

He stayed in South Korea only when work required it and stayed in the U.S. whenever he could. When Acone stayed in South Korea, he always stayed in the same hotel, provided to him at no cost by the airline, but stayed in various rooms in that hotel.

Acone retained his U.S. citizenship, voting registration, driver's license, bank accounts, and church membership.

On their tax returns for 2011 and 2012, the Acones claimed an exclusion for "foreign earned income" under §911(a)(1). IRS disallowed the exclusions.

The Court held that the taxpayer failed both the tax home and the bona fide residence tests and therefore did not qualify for the foreign earned income exclusion.

Tax home/abode test. The Court said that "abode" has been variously defined as one's home, habitation, residence, domicile, or place of dwelling. (Black's Law Dictionary 7 (5th ed. 1979)) While an exact definition of "abode" depends upon the context in which the word is used, it clearly does not mean one's principal place of business. Thus, "abode" has a domestic rather than vocational meaning, and stands in contrast to "tax home" as defined for purposes of §162(a)(2).

The Court said that one's abode is where he abides. The word connotes stability, not transience. Mr. Acone's housing in Seoul, however, was a hotel - the quintessence of transience. Admittedly, it is not impossible that a person may reside permanently in a hotel, but Mr. Acone did not have even a particular hotel room to call his own. The facts about his hotel life in Seoul were not absolutely dispositive of the issue of his "abode," but they were significant. The Court said that even though a taxpayer may have some limited ties to a foreign country, if the taxpayer's ties to the U.S. remain strong, the Tax Court has previously held that his abode remained in the U.S., especially when his or her ties to the foreign country were transitory or limited. See, e.g., Harrington, (1989) 93 TC 297. Mr. Acone's ties to South Korea were indeed limited; and his ties to the U.S. remained strong.

The Court said that the record clearly indicated that, while Mr. Acone spent significant periods in both South Korea and the U.S. during the years in issue, when he had the choice, he preferred to be in the U.S. A comparison of days off-duty in South Korea and the U.S. during the years in issue showed that, using Mr. Acone's own figures, he spent over 80% of the combined total of such days in the U.S. The mean lengths of his visits to each country during the years in issue indicated a similar conclusion: during both years, the mean duration of Mr. Acone's stays in the U.S. was days longer than the mean duration of his stays in South Korea. That is, when Mr. Acone was in America, he tended to stay there longer than he stayed in South Korea when he was there. "It would be difficult to conclude that Mr. Acone's 'domestic' home, as opposed to his professional home, was in a country where he largely declined to spend his personal days."

The parties agreed that Acone did not meet the "330 full days" test of §911(d)(1)(B). And the Court found that eight Sochurek factors weighed against finding bona fide residence in South Korea and three weighed in favor, so it concluded that the taxpayer failed the bona fide residence test. Included in its analysis were:

1. **Intention.** The Court stated that intent plays perhaps the most important part in determining the establishment and maintenance of a foreign residence. And it said that it took as sincere Mr. Acone's testimony that he intended to be a bona fide resident of South Korea. But the relevant intention is not merely the intention to make plausible a claim of the foreign earned income exclusion. Rather, courts look for objective indicia of an intention to actually establish residence in the foreign country. The Court said that it did not see any concrete, objective fact which persuasively demonstrated Mr. Acone's intent. Mr. Acone testified very credibly that in 2006 he intended to work for KAL until retirement - an intention that he accomplished - but he did not

convince the Court that, while so employed, he intended to be anything more than a transient in South Korea. So this factor was adverse to Mr. Acone.

2 **Establishment of home.** Mr. Acone did not establish a home in South Korea for any period, let alone an indefinite one. He simply stayed in whatever hotel room was made available to him at the Hyatt Regency Incheon. His actual home remained in the U.S., and he returned to it as frequently as practically possible. This factor was adverse to Mr. Acone.

3. **Activities and assimilation.** Mr. Acone testified credibly that he attempted to learn Korean to a modest extent and that he made friends with whom he ate and played golf and tennis in South Korea. To some extent, he did assimilate into the local environment, although the extent was not great, given how little of his free time he spent in South Korea. This factor was moderately favorable to Mr. Acone.

The Tax Court also distinguished the facts in the current case from two cases involving pilots who were deemed to qualify for the foreign earned income exclusion.

In *Jones,* (CA 5 1991) 67 AFTR 2d 91-795, the taxpayer was only away from his home in Japan when his business required it, or when he was on vacation. Mr. Acone, on the other hand, was away from South Korea and in the U.S. whenever his work permitted. The taxpayer in Jones returned a dividend check that the State of Alaska issued to him as a resident, fairly clearly establishing his intent (the first and most important Sochurek factor) not to be a resident of Alaska but instead to be a resident of the foreign country, Japan.

In *Cobb,* TC Memo 1991-376, the taxpayer accepted a permanent transfer to, and had a permanent duty assignment in Japan. While he did sometimes visit with his family when laid over in Los Angeles, the occasions were merely visits.

Adkins, (CA FC 5/8/2017) 119 AFTR 2d ¶ 2017-737.

The Court of Appeals for the Federal Circuit has held that the Court of Federal Claims misinterpreted two portions of Regulation §1.165-1(d), the regulation that provides that a theft loss is not sustained if, in the year the loss is discovered, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery. As a result, the Appeals Court vacated and remanded the lower court's holding that the taxpayers' loss was not deductible in the year in which claimed.

A theft loss is allowed in the year in which it is sustained (§165(a)), and taxpayers are considered to have sustained a theft loss in the year in which they discover it. (§165(e)) However, regulations explain that a theft loss is not sustained if, in the year of discovery, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery. No portion of the loss with respect to which reimbursement may be received is sustained until the tax year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received. (Regulation §1.165-1(d)(3))

Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement is a question of fact to be determined upon an examination of all facts and circumstances. Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim. When a taxpayer claims that the tax year in which a loss is sustained is fixed by his abandonment of the claim for reimbursement, he must be able to produce objective evidence of his having abandoned the claim, such as the execution of a release. (Regulation §1.165-1(d)(2)(i))

In February 2002, the Adkinses, discovering that they had been the victims of fraud by Donald & Co., their stockbrokers, submitted a statement of claim to the National Association of Securities Dealers (NASD) in support of arbitration against Donald & Co.

In 2003, the Adkinses learned of the existence of a criminal investigation of Donald & Co. and associated individuals, the Adkinses' attorneys were advised by the U.S. Attorney that an indictment would soon be issued, and the Adkinses' attorneys were further advised that the U.S. Attorney would request that all civil litigation, including arbitration proceedings, be stayed pending the resolution of the criminal proceedings.

In 2003, the Adkinses' arbitration attorneys requested that the arbitration hearing be postponed. They also suggested to the Adkinses that they allow the arbitration claim to remain open in the event that the criminal proceedings revealed useful information. The Adkinses did not object to this suggestion; the arbitration proceedings remained open, but inactive. The Adkinses did not make any further payments to their arbitration attorneys in 2003 or beyond.

The arbitration proceedings remained open but inactive in 2004; the Adkinses' arbitration attorneys took no action except to respond to NASD inquiries with requests for further postponements. In May 2004, the Donald & Co. principals were indicted; both were charged with securities fraud. The indictment contained criminal forfeiture allegations.

Mr. Adkins saw the indictment, and became aware of the charges against the Donald & Co. principals in 2004. He was advised by his arbitration attorneys that the arbitration proceedings were "trumped" by the indictment. Mr. Adkins believed that, as part of the criminal proceedings, the government would seize all of the criminal defendants' assets, as well as any documentation regarding their assets, foreclosing the Adkinses' ability to collect an arbitration award.

The Adkinses' arbitration proceedings remained open but inactive from 2005 through 2007. The Adkinses did not formally withdraw their arbitration claim until 2008.

The taxpayers took a theft loss deduction on their 2004 tax return. IRS challenged that deduction, and the taxpayers brought an action in the Court of Claims.

At their Claims Court trial, the Adkinses argued that, in 2004, they ascertained with reasonable certainty that they would not recover anything on their arbitration claim. The court said that the facts reflected that the Adkinses did not arrive at this conclusion because they settled or litigated the claim, but instead came to believe that the claim was no longer viable because they would not be able to collect on it, and therefore stopped actively pursuing it. In other words, the Claims Court said, the Adkinses contended that they abandoned their arbitration claim.

The Court of Claims held that the Adkinses did not meet their burden of establishing that they abandoned their claim in, and therefore sustained their theft loss in, 2004. (*Adkins,* (Ct Fed Cl 2016) 117 AFTR 2d 2016-779)

The Adkinses argued that the Claims Court misinterpreted an aspect of Regulation §1.165-1(d)(3), and the Appeals Court agreed.

The Appeals Court said that the Claims Court looked to the "reasonable prospect of recovery" and "ascertained with reasonable certainty" language in Regulation §1.165-1(d)(3) and said that, although other courts "tend to combine the 'reasonable prospect of recovery' inquiry and the 'ascertain with reasonable certainty' inquiry," the "two inquiries are distinct and the standards to be applied are different." This means that taxpayers are required to make a stronger evidentiary showing when attempting to claim their loss in any year subsequent to discovery. For example, an "estimate" made by lawyers and accountants may be sufficient to determine whether there was a reasonable prospect for recovery in the year of discovery, but it would not be sufficient to ascertain with reasonable certainty. Because the Adkinses discovered their loss in 2002 and attempted to claim their loss in 2004, the Claims Court applied the higher, more stringent standard of "reasonable certainty" - and held that the Adkinses failed to meet that standard.

The Adkinses argued that Regulation §1.165-1(d)(3), properly interpreted, does not set forth two different standards. Rather, Regulation §1.165-1(d)(3) merely describes two sides of the same probabilistic coin: a "reasonable prospect for recovery" is the inverse of "reasonable certainty" that there will be no recovery. That is, the test in Regulation §1.165-1(d)(3) may be simplified as follows: the proper year in which to claim a loss is the first year in which no reasonable prospect of recovery exists anymore, starting with the year of discovery. Accordingly, the Adkinses suggested, they should not have been held to a stricter standard to claim their loss in 2004 than the standard to which they were held for 2002.

The Appeals Court agreed with the Adkinses' interpretation of the Regulation It said that, while few of the other circuits have addressed this issue explicitly, those few that have appear to have reached the same conclusion. For example, *Vincentini,* (CA 6 2011) 108 AFTR 2d 2011-5247, described Regulation §1.165-1(d)(3) as setting forth a single test and described that test as whether the taxpayer demonstrated with reasonable certainty that there was no reasonable prospect of recovery. The Court here said that it found no basis in the language of Regulation §1.165-1(d)(3) to deviate from this "straightforward and sensible approach."

The Appeals Court said that this interpretation aligns with common sense incentives for victims of theft. Good-faith efforts to recover losses - such as lawsuits and arbitration - will tend to push the claim year later than the year of discovery by creating a probability of recovery. To the extent that it is rendered more difficult to succeed on a loss claim in years subsequent to discovery, taxpayers will be dissuaded from those good-faith efforts. "Neither the government nor the Claims Court has explained why such a result possibly could have been intended by the Treasury Department."

The Court also agreed with the Adkinses' second argument-that, under either interpretation of Regulation §1.165-1(d)(3), the Claims Court additionally erred by treating abandonment of their arbitration claim as a prerequisite to a reasonable certainty of no recovery.

The Adkinses argued that the Claims Court misinterpreted Regulation §1.165-1(d)(2)(i) when it concluded that the Adkinses' Claims Court argument was based on an abandonment of their arbitration claim. The Adkinses contended that the Claims Court effectively treated that regulation’s "settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim" language as an exhaustive list rather than a mere collection of examples.

The Adkinses conceded that their arbitration claim with NASD was still pending in 2004; nevertheless, they argued that a holistic examination of the facts and circumstances as of that time demonstrated a reasonable certainty of no recovery. The Adkinses note in particular that, as of 2004, they had reason to believe that: (1) the government intended to seize any documentation concerning the identity and ownership of the defendants' assets, foreclosing independent investigation; (2) the government intended to seize all of defendants' discovered assets; and (3) the defendants had no chance of generating future assets given their plea agreements and debarments.

The Court said that it read Regulation §1.165-1(d)(2)(i) as setting forth a general totality-of-the-circumstances standard, followed by an alternative method for a taxpayer to demonstrate that no reasonable prospect of recovery existed as of a certain date. That is, rather than make their case under the general "all facts and circumstances" standard, a taxpayer may rely on the date that their arbitration or lawsuit for the loss was settled, abandoned, or adjudicated. In the case of abandonment, because no dated court order or settlement agreement exists, the taxpayer must be able to provide some other form of "objective evidence" as to when abandonment occurred. But even in cases where the taxpayers do have a related arbitration or lawsuit, "we do not read Regulation §1.165-1(d)(2)(i) as precluding them from making their case under the more general standard, should they so choose."

The Court then said that it recognizes that the existence of a live arbitration or lawsuit typically is at least probative evidence of the potential for recovery. A taxpayer's decision to incur the costs associated with maintaining such a proceeding reveals something about their subjective beliefs regarding the potential for recovery therein. But courts must take into account what those costs actually are. In this case, for example, the Adkinses' arbitration attorneys took no action after 2004 other than requests for further postponements. The Adkinses were no longer even paying the arbitration attorneys after 2003. Where, as appeared to the Court to be the case here, the associated maintenance costs are almost zero, the taxpayer's decision to keep the proceeding open tells the court exceedingly little about their beliefs as to the chances for recovery. Accordingly, unless the taxpayer has chosen abandonment (or settlement or adjudication) as the factual predicate for their loss date, the existence of an ongoing lawsuit or arbitration is only one factor to be considered among many-i.e., all of the facts and circumstances.

The Appeals Court went on to say that, because the Adkinses did not choose abandonment as the factual predicate for their loss date, it vacated and remanded the Claims Court's decision, with a direction to the Claims Court to engage in an analysis that goes beyond the consideration of abandonment and to conduct additional factfinding as necessary.

Alexander, TC Summary Opinion 2017-23.

The Tax Court, in a summary opinion, has held that a disbarred attorney had to treat as taxable nonemployee compensation amounts he received for assisting a licensed attorney with his cases. The amounts were paid for services rendered rather than gifts made from a detached and disinterested generosity.

Compensation for services is included in gross income under §61, while a gift is excluded from gross income under §102.

Payments or transfers to nonemployees are a gift, rather than compensation for services for tax purposes, if the payment or transfer is made from detached and disinterested generosity, out of affection, respect, admiration, charity, or like impulses. The payment is not a gift if it's primarily the result of a legal or moral duty, is a reward for services rendered, or is made because of the incentive of an anticipated benefit of an economic nature. The transferor's intention is determined by an objective inquiry.

William Alexander practiced law in the fields of workers' compensation and Social Security disability matters for approximately 35 years, and considered himself an expert in these fields. In 2011, he ceased practicing law because (1) he was suffering from serious medical problems and (2) the State of Colorado had suspended him from the practice of law. In 2012, Alexander was permanently disbarred from the practice of law.

By 2012, Alexander's health had improved to the point he was able to work for Steven Mullens, another workers' compensation attorney. Alexander and Mullens were well known to each other in the workers' compensation community. Indeed, after Alexander ceased practicing law, most of his former clients were referred to Mullens' firm. Mullens was involved in a Federal class action lawsuit against Wal-Mart and Concentra Health on behalf of all injured Colorado residents that had worked for Wal-Mart, and asked Alexander to assist him in the litigation even though Mullens was aware that Alexander had been disbarred.

Alexander agreed to help Mullens and asked to be paid $100 per week for gas and meals expenses while working on the case. Mullens agreed to Alexander's request. Alexander reviewed materials and documents in 30 boxes of Wal-Mart's claims adjusters' files and prepared written summaries of each file in an attempt to document Mullens' and his beliefs that insurance adjusters working for Wal-Mart had often dictated the medical care to be provided by Concentra doctors to the injured workers. Alexander worked at Mullens' office approximately four hours a day, four or five days per week, for eight weeks. Alexander estimated he worked 160 hours on the Wal-Mart litigation. Mullens asked Alexander to submit a bill for the hours he worked on the case. On the eve of trial the lawsuit was settled.

After completing his Wal-Mart work, Alexander did "private work" for Mullens. This work consisted of performing legal research, drafting briefs and responses, and preparing memoranda for Mullens during the latter part of 2012. It was agreed that Mullens would pay Alexander according to the value of the case and the percentage of Alexander's contribution. Alexander worked between 50 and 100 hours on Mullens' "private work" in 2012.

In addition to paying Alexander $800 in reimbursements ($100 a week for eight weeks), Mullens made two payments to Alexander: (1) a $5,000 check, on an unspecified date in 2012, which Alexander at one time characterized as a loan that was ultimately forgiven and at another time as an advance for his "private work," and (2) a $10,000 check dated April 18, 2012.

Mullens' office issued a Form 1099-MISC, Miscellaneous Income, to Alexander for nonemployee compensation totaling $18,000. IRS conceded that Alexander received $15,800 rather than $18,000 from Mullens during 2012.

Alexander claimed that he did not receive a Form 1099-MISC from Mullens, which apparently was sent to an out-of-date address. He believed that Mullens had paid him less than he was worth as an experienced workers' compensation attorney, stating: "If he had told me that he was paying me this amount of money [i.e., the $15,800], I would have walked out of the office."

When Alexander learned that Mullens had received more than $1 million in legal fees for the Wal-Mart litigation, Alexander confronted him by phone, demanding more money. He followed up the phone call with a letter to Mullens stating that Mullens owed him "a reasonable wage."

Alexander asserted that the payments he received from Mullens were merely nontaxable gifts, and did not report them on his 2012 income tax return. IRS said the payments should have been treated as taxable nonemployee compensation.

The Tax Court noted that Mullens died before trial, so it could not ascertain for certain his intent in making the payments to Alexander. However, the Court said objective facts demonstrated that Alexander: (1) was paid after he performed work for Mullens; (2) submitted a timesheet showing the number of hours he worked, so that Mullens could submit the timesheets to the trial court "as a cost and get me paid."; (3) expected to be paid for his work on Mullens' "private work" according to the value of the cases he worked on and his contribution towards their success; (4) characterized the $5,000 payment first as a loan that was forgiven, which would not be a gift, (under §61(a)(12), discharge of indebtedness constitutes gross income), and then as an advance paid in anticipation of work he was to perform, which would also not be a gift; and (5) considered himself to be underpaid and confronted Mullens both on the telephone and by letter demanding a reasonable wage.

The Tax Court concluded that the totality of these objective facts indicated that Mullens did not intend the payments he made to Alexander to be gifts made from a detached and disinterested generosity.

The Tax Court also addressed Alexander's argument that the money he received could not be compensation because it would have been insufficient to induce him to work for Mullens. Alexander maintained that the motivation for rendering his services was "for the duty that he felt that he owed to the community of injured workers that have given him an acceptable lifestyle for more than 30 years." The Tax Court observed that when Alexander performed his work for Mullens, he was a disbarred attorney and Mullens knew this. Alexander was paid $15,000 for 210 to 260 hours of work, which amounted to $58 to $71 per hour. The Tax Court did not believe this to be an unreasonably low rate of pay for a disbarred attorney. It also ruled that the $800 expense reimbursement that Alexander received was includible in his income.

In sum, the Court found that the $15,800 that Mullens paid to Alexander was includible in 2012 income. It also found that he owed an accuracy-related penalty under §6662(a).

Austin, TC Memo 2017-69.

Stock held by two S corporation shareholders (each of whom held 47.5% of the stock) was subject to a substantial risk of forfeiture when issued to them and remained subject to that risk until the restrictions lapsed by its terms.

Under §83(a) if property is transferred to a taxpayer in connection with the performance of services, the excess of the fair market value of the property over the amount, if any, paid for the property, is included in the taxpayer's gross income in the first tax year in which the taxpayer's rights in the property are transferable or are not subject to a substantial risk of forfeiture. The rights of a person in property are subject to a substantial risk of forfeiture if the person's rights to full enjoyment of the property are conditioned upon the future performance of substantial services by any individual (sometimes termed an "earnout" restriction). (§83(c)(1))

Property is not transferred subject to a substantial risk of forfeiture if at the time of transfer the facts and circumstances demonstrate that the forfeiture condition is unlikely to be enforced. The regulations provide the following five factors for determining whether the possibility of forfeiture is substantial in the case of rights in property transferred to an employee of a corporation who owns a significant amount of the stock of the employer corporation: (i) the employee's relationship to other shareholders and the extent of their control, potential control and possible loss of control of the corporation; (ii) the employee's position in the corporation and the extent to which he is subordinate to other employees; (iii) the employee's relationship to the officers and directors of the corporation; (iv) the person who must approve the employee's discharge; and (v) the employer's prior actions in enforcing the provisions of the restrictions. (Regulation §1.83-3(c)(3)

For purposes of subchapter S, stock that is issued in connection with the performance of services and substantially nonvested is not treated as outstanding stock of the corporation, and the holder of such stock is not treated as a shareholder solely by reason of holding it (unless the holder makes a §83(b) election to include an amount in gross income in the year of transfer). (Regulation §1.1361-1(b)(3))

Observation: For the period at issue in this case, the S corporation provisions created a framework under which all the outstanding shares of an S corporation could be treated as owned by an ESOP, making the company's income exempt from Federal income tax. The Court noted this arrangement was well known and frequently used by tax practitioners. In 2001, Congress amended the Code to attribute to certain non-ESOP shareholders of a closely held S corporation any income allocated by it to an employee stock ownership plan (ESOP). (Economic Growth and Tax Relief Reconciliation Act (EGTRRA) sec. 656(d) (codified as §409(p)). However, this change was made prospective only and generally did not apply to plan years before 2005 for an ESOP (like the ESOP in these cases) that existed before 2001.

In a §351 transaction in December of 1998, Larry Austin and Arthur Kechijian (the taxpayers) each transferred his respective ownership interests in a group of related corporations and limited liability companies (the UMLIC entities), with a cost basis of $142,566, to a newly formed S corporation holding company called UMLIC Consolidated, Inc. (UMLIC S-Corp). In exchange, they each received 47,500 shares of UMLIC S-Corp's common stock.

The taxpayers each executed a "Restricted Stock Agreement" (RSA) and an "Employment Agreement" with UMLIC S-Corp which required them to perform future services for UMLIC S-Corp in order to secure full rights in their stock. These agreements specified a 5-year "earnout" period and provided that either taxpayer would forfeit 50% of the value of his shares if he voluntarily terminated his employment with UMLIC S-Corp before January 1, 2004. Consent from 100% of the holders of UMLIC S-Corp shareholders was required to remove or waive this restriction.

In December of 1998, UMLIC S-Corp funded an ESOP with a $500,000 loan, which was used to purchase 5,000 shares of its common stock. As of December 18, 1998, each taxpayer owned 47.5% of the company's common stock with the ESOP owning the remaining 5%.

In August of 1999, each taxpayer established an irrevocable grantor trust for the benefit of his family, with each transferring 24,500 shares of UMLIC S-Corp common stock (which was still subject to the RSA) to his trust in exchange for a $1.83 million promissory note.

In late 2003, the taxpayers reorganized the ownership structure of their business. Under the plan, all of UMLIC-S Corp's assets, consisting principally of its operating subsidiaries, would be transferred to a new holding company wholly owned (directly or indirectly) by the taxpayers. The new holding company, which would thereafter conduct the same business, would be organized as an LLC, thus facilitating possible investment by private investors. UMLIC S-Corp would be left with cash equivalents, essentially "freezing" its value-and the value of the 5% stake held by the ESOP-as of the date the sale was consummated. In addition, the new holding company would acquire a stepped-up basis in the acquired assets for depreciation and amortization purposes.

In October of 2003, taxpayers formed UMLIC Holdings LLC (Holdings), as the acquiring company, with each taxpayer (through intermediaries) holding a 50% membership interest. Because UMLIC S-Corp proposed to sell substantially all of its assets to Holdings, the transaction had to be approved by the former's shareholders, including the ESOP. To avoid potential conflicts of interest, the taxpayers (who made up two of the ESOP's five trustees) resigned their roles as co-trustees. UMLIC S-Corp's controller was selected to serve as successor co-trustee with another senior employee; both were ESOP beneficiaries.

In December of 2003, the taxpayers engaged in a series of transactions that caused UMLIC S-Corp to reincorporate in another state (renamed UMLIC Consolidated, Inc. (New UMLIC S-Corp)) and elect to be an S corporation. At that time, all of the stock held by the taxpayers and their grantor trusts was converted to New UMLIC S-Corp stock.

On January 1, 2004, the restrictions on the taxpayers' stock (now New UMLIC S-Corp stock) lapsed. The fair market value of the 47,500 shares of stock held by each taxpayer and his grantor trust was $45,857,434.

The taxpayers executed a series of transactions in order to avoid having to report this amount of their 2004 returns as compensation subject to income and employment tax. On March 30, 2004, each taxpayer entered into a "surrender agreement" and a "subscription agreement" with New UMLIC S-Corporation These agreements provided that each taxpayer would surrender his 47,500 unrestricted shares and simultaneously repurchase 47,500 identical shares in exchange for a $41.5 million promissory note with a 10- year term. On June 30, 2004, New UMLIC S-Corp paid a distribution (the "special dividend") of $35 million. Each taxpayer received $8.47 million for his 23,000 shares. Each of their grantors trust received $9.03 million for their 24,500 shares.

The taxpayers contended that their stock in UMLIC S-Corp was subject to a substantial risk of forfeiture when they received it in December of 1998 and remained subject to a substantial risk of forfeiture until January 1, 2004, when the 5-year earnout restriction lapsed.

Because the 95,000 shares owned by the taxpayers and their grantor trusts were deemed to be "non-outstanding," UMLIC S-Corp for tax years 2000-2003 allocated 100% of its income, losses, deductions, and other tax items to the ESOP. Consistently with this reporting, neither taxpayer reported any flowthrough items from UMLIC S-Corp on their returns for 2000, 2001, 2002, or 2003. (And because the ESOP was a tax-exempt entity, it likewise reported no taxable income from UMLIC S-Corp for 2000-2003.)

For 2004, each taxpayer took the position that he had "surrendered" his original shares and acquired replacement shares worth $46 million in exchange for a $41.5 million promissory note. Accordingly, each reported the difference between those amounts, or $4.5 million, as compensation income under §83. They contended that they and their grantor trusts had acquired an increase in basis in the New UMLIC S-Corp shares by virtue of the respective $41.5 million promissory notes so that the $35 million "special dividend" merely reduced their respective bases and generated no additional taxable income to either.

On the other hand, IRS contended that the taxpayers' stock was substantially vested when they received it in December of 1998; that their stock was thus "outstanding" for subchapter S purposes throughout the tax years at issue; and that the taxpayers consequently had been required to report their pro rata shares of the company's income on their 2000-2003 returns. IRS further determined that the taxpayers did not have sufficient bases in their New UMLIC S-Corp stock to make the 2004 special dividend nontaxable.

The Tax Court concluded that the taxpayers' stock was subject to a substantial risk of forfeiture when issued to them in 1998 and remained subject to that risk until the restrictions lapsed on January 1, 2004.

As a threshold matter, the Tax Court rejected IRS's contention: (1) that §83 was inapplicable because the taxpayers supplied only property and no substantial future services in exchange for the UMLIC S-Corp stock; and (2) that the taxpayers could not have received stock that was "substantially nonvested" for §83 purposes, and yet concurrently have "owned" at least 80% of the total combined voting power of all classes of UMLIC S-Corp stock as required for income nonrecognition under §351(a) and §368(c). The Court reasoned that the RSAs and the employment agreements by their terms required the taxpayers to perform substantial future services for UMLIC S-Corp to receive the full value of their stock. And Regulation §1.1.1361-1(b)(3) by its terms only applies for purposes of subchapter S and IRS cited no authority for the proposition that it would disable a stock-for-stock exchange.

The Court found that the key question in this case was whether-if either of the taxpayers had quit his job before the end of the 5-year earnout period-UMLIC S-Corp would likely have enforced the restriction requiring that he forfeit 50% of the value of his shares. Analyzing the factors under Regulation §1.83-3(c)(3), the Court concluded that the answer to this question was "yes."

Given the complementary nature of the taxpayers' responsibilities and skill sets, it was in each taxpayer's economic interest to have the other remain with the company. To incentivize this, they executed reciprocal agreements under which each would lose 50% of the value of his stock if he left the company within five years; as the Court expressed it, they thus "tied each other to the mast" for a five year period. Further, if the departing taxpayer forfeited 50% of the value of his stock, the value of the remaining taxpayer's stock (and that of the ESOP) would be increased accordingly.

Conceivably, both taxpayers might have decided independently that they wished to retire early instead of serving out their promised 5-year terms. However, the ESOP had a strong economic incentives to refuse such consent: (a) if the taxpayers left the company, the company might well fold, and the ESOP beneficiaries would then lose their jobs; and (b) if the taxpayers forfeited 50% of the value of their stock, the value of the ESOP's stock would be increased astronomically.

The Court dismissed IRS's argument that the taxpayers could control the other ESOP trustees to vote for consent or waiver, finding that IRS ignored the fiduciary duties that the trustees owed the ESOP. Further, the Court found that the taxpayers themselves would not have acted as ESOP trustees for such a vote because approving the removal of the forfeiture provision affecting their shares would have been directly contrary to the economic interest of the ESOP and a "grotesque" conflict of interest for the taxpayers. The Court was confident that the taxpayers in such circumstances would have resigned as trustees, as they did in 2003, rather than face the consequences of a self-dealing charge.

The Tax Court also reject IRS's contentions (1) that the incorporation of UMLIC S-Corp as a holding company lacked a legitimate business purpose and was devised solely to avoid taxes; and (2) that the ESOP lacked economic substance because was a mere "accommodation party" that enabled the taxpayers to defer receipt of income from UMLIC S-Corporation The Court found that the taxpayers observed all corporate formalities in creating and operating the holding company structure, and it had economic substance apart from tax considerations. It also reasoned that although the UMLIC entities previously had a section 401(k) plan in place, the Code did not prevent the taxpayers from providing an additional incentive in an effort to retain existing employees through the ESOP, whose beneficiaries included all of the company's eligible employees.

However, the Tax Court found that despite the simultaneous "surrender" and "subscription" agreements with New UMLIC S-Corp, §83(a)(1) required that the fair market value of stock be treated as compensation income to the shareholder "at the first time" the stock becomes substantially vested. That occurred on January 1, 2004, and §83 requires a "snapshot" valuation as of that date. The value of the stock each owned on January 1, 2004, directly or through his grantor trust, was $45,857,434. Each thus received taxable compensation in excess of $45 million at that time. No subsequent actions with respect to the stock, whether a sale to a third party or surrender to the corporation, could change that. Further, this $45,714,868 income inclusion under §83 provided a basis increase under Regulation §1.83-4(b)(1) so that each taxpayer's basis in his New UMLIC S-Corp shares was increased by this amount.

In any event, the Court determined that it was clear that the simultaneous "surrender" and "repurchase" transactions were palpably lacking in economic substance, motivated by no business purposes other than obtaining tax benefits. Neither taxpayer could envision a reasonable possibility of profit by surrendering, for no consideration, stock worth $45.8 million, and no rational person would incur indebtedness of $41.5 million to acquire stock that he already owned free and clear. In addition, the notes themselves lacked economic substance since each taxpayer then owned a 50% interest in New UMLIC S-Corp, so each was in effect issuing, for no rational business purpose, a $41.5 million promissory note to himself.

Estate of Backemeyer, (2016) 147 TC No. 17.

The tax benefit rule did not require the recapture of deductions for farm supplies claimed by a taxpayer on his 2010 return upon his death in 2011 where his surviving spouse, who acquired these farm supplies by inheritance, deducted their expense in 2011.

Under the Supreme Court's decision in *Bliss Dairy v. U.S.* (S Ct 1983) 51 AFTR 2d 83-874, the tax benefit rule may apply not only where there is an actual "recovery" of an amount previously deducted, but also where a later unforeseen event is "fundamentally inconsistent with the premise on which the deduction was initially based." Thus, an amount which was previously deducted must be included in income if the deduction would have been foreclosed if the unforeseen event had occurred in the same tax year.

In *Frederick,* (1993) 101 TC 35, the Tax Court determined that an amount must be included in gross income in the current year under the tax benefit rule to the extent that (1) it was deducted in a prior year, (2) the deduction resulted in a tax benefit, (3) an event occurs in the current year that is fundamentally inconsistent with the premises on which the deduction was originally based, and (4) a nonrecognition provision of the Code does not prevent inclusion in gross income.

Steve and Julie Backemeyer were husband and wife. Mr. Backemeyer was a sole proprietor farmer. He purchased certain "farm inputs" (generally, tangible personal property used in agricultural production, such as seed, fertilizer, herbicides, and fuel) in 2010 intending to use them to cultivate crops the following year. Mr. Backemeyer, a cash-method taxpayer, deducted his expenditures on the inputs under §162 for that same tax year. His 2010 Schedule F reported the following expenses related to his farming business: $20,769 for chemicals, $203 for custom hire (machine work), $107,011 for seeds and plants purchased, $98,920 for fertilizer and lime, and $8,790 for gasoline, fuel, and oil.

Mr. Backemeyer died in March of 2011 not having used any of the purchased farm inputs. They were subsequently transferred to his wife, who began her own farming business as sole proprietor upon his death. Mrs. Backemeyer used all the farm inputs in 2011 to grow crops that were then sold in 2011 and 2012.

For tax year 2011, Mrs. Backemeyer deducted an amount equal to the value of the farm inputs inherited from Mr. Backemeyer. The 2011 Schedule F for Mrs. Backemeyer reported various farming expenses, including the following expenses in amounts equal to those reported on Mr. Backemeyer's 2010 Schedule F: $20,769 for chemicals, $203 for custom hire (machine work), $107,011 for seeds and plants purchased, $98,920 for fertilizer and lime, and $8,790 for gasoline, fuel, and oil.

On audit, IRS determined that Mrs. Backemeyer was not entitled to deduct the $20,769 for chemicals, $203 for custom hire (machine work), $107,011 for seeds and plants purchased, $98,920 for fertilizer and lime, and $8,790 for gasoline, fuel, and oil. Mrs. Backemeyer conceded that the deduction of $203 for custom hire on her 2011 Schedule F was in error, the result of an accounting mistake or clerical problem with the tax return.

IRS maintained that the tax benefit rule required the inclusion in Mr. Backemeyer's 2011 income of the prepaid expenses for the farm inputs that he had deducted for 2010.

On the other hand, Mrs. Backemeyer maintained that the third and fourth parts of the Frederick test were not satisfied here: had Mr. Backemeyer died in 2010 instead and Mrs. Backemeyer used the inputs that same year, then Mr. Backemeyer would still have been entitled to the deduction. And since §1001 required a taxpayer to recognize gain only to the extent sale proceeds exceed basis, no gain was recognized since there was a basis step-up under §1014.

In evaluating the application of the tax benefit rule to the taxpayer's deduction under §162 of certain farm input expenditures, the Court applied the analysis mandated by the Supreme Court in *Bliss Dairy* and distilled by the Tax Court in *Frederick* to conclude that the tax benefit rule does not require the recapture upon Mr. Backemeyer's death in 2011 of deductions he claimed for 2010 for his expenditures on the farm inputs.

The Tax Court reasoned that, with regard to the third factor under the Frederick test, neither Mr. Backemeyer's death nor the distribution of the farm inputs to and their use by Mrs. Backemeyer was fundamentally inconsistent with the premises on which the initial §162 deduction for the 2010 tax year was based. A current event is considered fundamentally inconsistent with the premises on which the deduction was originally based when the current event would have foreclosed the deduction if that event had occurred within the year that the deduction was taken.

The sole cause for the allowance of two deductions here was §1014(a), which steps up the basis of property acquired from a decedent. Were §1014 not to apply, then Mrs. Backemeyer would have received the farm inputs with a zero basis and so been unable to deduct them. Since Congress presumably enacts legislation with knowledge of the law, the Court concluded that had Congress wished to foreclose a second §162 deduction as a result of a §1014 basis step-up, it would have so provided. It was hardly unforeseeable that taxpayers would attempt to deduct previously expensed inherited assets for which they received a stepped-up basis, yet at no point has Congress acted to prevent it. Far from resulting in a double deduction, the provision for and maintenance of a stepped-up basis under §1014 is a deliberate legislative choice by Congress to prevent double taxation.

The Tax Court further found that the fourth factor under the Frederick test, which mandates that a nonrecognition provision of the Code not prevent the inclusion of the tax benefit in gross income, was not met here. When an individual dies, his assets are not taxed under the income tax but rather under the estate tax. Upon the assets' distribution to the decedent's heirs, §102(a) explicitly provides that the heirs' gross income does not include the value of property acquired by "gift, bequest, devise, or inheritance." And, §1014 operates to provide a step-up in basis of the inherited property in the hands of the decedent's heirs so that if an heir subsequently disposes of the property, gain is realized only to the extent the proceeds exceed the stepped-up basis. (§1001(a))

The Tax Court noted that the tax benefit rule must be applied on a case-by-case basis. The Tax Court further pointed out that in Bliss Dairy, the Supreme Court recognized that its decision did not extend necessarily to transfers by gift or death.

The Court further determined that the §6662 accuracy-related penalty for a substantial understatement of income tax did not apply, since the Backemeyers' deductions of the inputs under §162 were appropriate, and the sole denied deduction conceded by the Backemeyers (the $203 deduction mistake) was not large enough to merit imposition of the penalty.

Barrett, TC Memo 2017-195

The Tax Court has held that a self-employed taxpayer's tax home was in Las Vegas because he did most of his self-employment work from his Las Vegas home and had rental properties in the Las Vegas area, and despite the fact that he regularly had to go to Washington, DC for his work and rented an apartment there.
Under §162(a)(2) , a deduction is allowed for ordinary and necessary business expenses paid or incurred during the tax year in carrying on a trade or business, including expenses for travel away from home.

A taxpayer' s tax home, i.e., his home for purposes of the business-travel deduction rules, is located at (1) his regular or principal (if more than one regular) place of business, or (2) if the taxpayer has no regular or principal place of business, his regular place of abode in a real and substantial sense. (Rev Rul 73-529, 1973-2 CB 37)

When taxpayers have multiple jobs in different locations during the year, are married, and incur duplicate living expenses, identifying the location of the tax home requires review of multiple factors, including: (1) whether employment is permanent, temporary, or indefinite; (2) whether there is a business justification for incurring duplicate living expenses; and (3) whether the spouses have separate tax homes. (*Allen,* TC Memo 2009-102)

The taxpayers, Mr. and Mrs. Barrett, resided in Las Vegas at all times during the years at issue, 2011-2014. They owned rental properties in the Las Vegas area. Mr. Barrett arranged for and supervised repairs on the rental properties. Mrs. Barrett had a job in the Las Vegas area.

Mr. Barrett had been in the video production business since the mid-1980s and began working for a client, AIPAC, in 1995. For the years at issue, he performed services for clients other than AIPAC but did not receive any income for such other services.
Video production includes writing scripts and reviewing footage, much of which Mr. Barrett did out of an office in his Las Vegas home. Interviews relating to the videos were conducted in various locations around the world.

2007, AIPAC built a new building in Washington, DC. Thereafter AIPAC required Mr. Barrett to travel to DC to use the editing facilities and the library at AIPAC's building to perform postproduction activities. Mr. Barrett continued to write scripts and perform preproduction services in his Las Vegas home. The average duration of Mr. Barrett's stays in DC was two weeks. Initially he stayed at hotels, but from 2007 through June 2013, he rented a condominium apartment because he and AIPAC agreed that an apartment would be more cost efficient than hotel stays. AIPAC reimbursed Mr. Barrett for some meals and expenses when he was in DC.

Mr. Barrett reported his income from the video production business on Schedules C; he reported substantial deductions for DC travel, meals and entertainment expenses on those Schedules C.

IRS disallowed those expenses, arguing that Mr. Barrett's tax home was DC. The Barretts argued that the deductions were allowable because Mr. Barrett's tax home was Las Vegas. Taxpayer's tax home was in Las Vegas. Because Mr. Barrett performed substantial services for AIPAC in Las Vegas, traveled to DC only to complete the production process, was required to be in DC only a few weeks at a time, and had other income-producing activities in the Las Vegas area, the Court concluded that Las Vegas was Mr. Barrett's tax home.

IRS's argument was that Mr. Barrett's tax home was in DC because his work for AIPAC over a period of 21 years was "permanent" rather than temporary and produced the bulk of the Barretts' total income for the years in issue.

The Court said that, in considering whether employment is permanent, temporary, or indefinite, the general rule is that if the location of the taxpayer's regular place of business changes, so does the taxpayer's tax home - from the old location to the new location. There is an exception to this rule if the employment is, or is reasonably expected to be, temporary. Unless termination within a short period is foreseeable, employment that merely lacks permanence is considered indefinite.

The Court concluded that, although Mr. Barrett's work with AIPAC was long term, his travel to DC was sporadic and for short periods totaling less than half a year.
The second factor for identifying the tax home is that the taxpayers must have some business justification beyond merely personal reasons for maintaining an alleged tax home remote from a place of employment. Here, the Court said that Mr. Barrett performed some business services and had rental activities to justify maintaining a home in Las Vegas. Third, when married couples maintain multiple places of abode, review is required to determine whether they have separate tax homes. The Court said that, in this case, it did not have to conclude that the Barretts had separate tax homes because there are no travel deductions in issue relating to the employment of Mrs. Barrett.

IRS "relie[d] heavily" on the assumption that AIPAC's payments to Mr. Barrett were solely for work performed during his trips to DC, while Mr. Barrett testified that much of his work was performed in his home office in the Barretts' Las Vegas residence. Mr. Barrett testified that 75% of his time was spent outside of DC, interviewing on location and writing scripts and reviewing footage in Las Vegas. The Court said that Mr. Barrett's testimony was uncontradicted and not improbable or unreasonable. IRS's assumption was not supported by any evidence. The Court said that it could not conclude that Mr. Barrett's income from AIPAC was attributable solely or primarily to work in DC.

Bell, (CA9, 7/10/2017) 120 AFTR 2d ¶ 2017-5043

In an unpublished opinion, the Court of Appeals for the Ninth Circuit has affirmed the Tax Court's holding that a couple's transfer of the assets of their sole proprietorship real estate brokerage to a newly formed corporation of which they owned all of the stock was a capital contribution to the corporation, not a sale of assets.

§385 gives IRS authority to issue regulations taking various factors into account in determining whether an interest in a corporation is to be treated as stock or debt. For the years involved in this case, IRS had not issued general regulations under §385. In the absence of those regulations, facts and circumstances determine whether an advance to a corporation is a capital contribution or a loan. The Ninth Circuit considers the following factors in determining whether an advance is debt or equity: (1) the name given to the documents evidencing the indebtedness; (2) the presence of a fixed maturity date; (3) the source of the payments; (4) the right to enforce payments of principal and interest; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of "dividend" money; and (11) the corporation's ability to obtain loans from outside lending institutions. No single factor is controlling; the facts and circumstances of each case must be taken into consideration. *Hardman,* (CA 9 1987) 60 AFTR 2d 87-5651)

§351(a) provides that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in the corporation and, immediately after the exchange, such person or persons are in control of the corporation. The basis of property received by a controlled corporation in a tax-free transfer, e.g. upon the incorporation of the corporation or otherwise, is equal to the basis of the property in the transferor's hands increased by any gain recognized by the transferor on the transfer. (§362(a))

Mr. Bell operated Realty World MBA, a real estate brokerage, as a sole proprietorship. His wife also worked in the business. A significant part of the business dealt with "real estate owned properties" (REOs), which were foreclosed properties that the Bells' assisted in repossessing, fixing up for sale, and listing to sell for the lender. In 2008, the Bells incorporated the business under the name MBA Real Estate, Inc. (MBA). They held all of the MBA stock. Shortly thereafter, MBA renewed Mr. Bell's franchise license agreement with Realty World-Northern California, Inc., for a renewal fee of $250.

MBA, Inc. and Mr. Bell then entered into a purchase agreement under which Bell agreed to sell to MBA, for $225,000, all of the proprietorship's "work in process, customer lists, contracts, licenses, franchise rights, trade names, goodwill, and other tangible and intangible assets." The purchase price was determined solely by the Bells; no appraisal was performed. The Bells allocated $25,000 of the purchase price to the 5-year franchise license agreement Mr. Bell entered into with Realty World-Northern California, Inc., in 2004 for $3,200. $200,000 of the purchase price was allocated to 40 contracts between Mr. Bell and various lenders to assist during the REO process.

The purchase agreement stated that the price was payable in monthly installments of $10,000 or more on the first of each month and that the unpaid principal amount was subject to 10% interest each year. MBA provided no security for the purchase price, and no promissory note was executed. The purchase price was eventually paid in full.

On their returns for the years at issue, 2008-2010, the Bells reported long-term capital gain from the sale transaction, using Form 6252, Installment Sale Income. They also reported interest income. MBA reported substantially the same amounts as interest payments on its returns for the years at issue. It amortized the $225,000 purchase price over five years.

IRS found deficiencies based on its determination that the transfer of the sole proprietorship's assets to MBA was a capital contribution subject to §351, not a sale. It argued that payments made to the Bells were actually dividends and that the assets transferred to MBA could not be amortized or depreciated.

The Tax Court concluded that the transfer of the assets was a capital contribution governed by §351, and not a sale, to MBA. It noted that where a series of closely related steps are taken under a plan to achieve an intended result, the transaction must be viewed as an integrated whole for tax purposes. The sole purpose of MBA's organization was to incorporate the sole proprietorship. The inseparable relationship between MBA's organization and the transfer of the sole proprietorship's assets weighed in favor of finding that the transfer was a capital contribution, particularly in the light of the lack of evidence of a business reason for dividing the transaction.

The Court then considered each of the Ninth Circuit's Hardman factors (since the case was appealable to that circuit), including the following, in reaching its conclusion:

a. **Agreement indicated debt**. The issuance of a note evidences debt, and the issuance of stock indicates an equity contribution. The purchase agreement provided that the purchase price was to be paid in installments of $10,000 or more on the first of each month. The unpaid principal amount was subject to interest at the annual rate of 10%. The wording in the purchase agreement was typical of a promissory note and did not contain wording commonly included in a stock certificate. This factor weighed in favor of finding that the transaction was a sale.

b. **Payment source**. Payments that depend on earnings or come from a restricted source indicate an equity interest. The purchase agreement had no caveats regarding payment of the purchase price. On its face, the payments were due even if MBA was not profitable. This interpretation was supported by evidence presented by the Bells indicating that one of the benefits of structuring the transfer of Realty World MBA's assets to MBA as a sale was that they would receive a steady stream of income each month "for several years until the purchase price was paid off without concern for the ups and downs of the business world." However, the Tax Court said it could not ignore the fact that MBA acquired essentially all of its assets, which had very little, if any, liquidation value, in exchange for its promise of repayment. Without income it would be impossible for MBA to make any payments due under the purchase agreement, and repayment was completely contingent on MBA's earnings. Consequently, this factor weighed in favor of finding a capital contribution.

c. **Participation and management**. An increase in a shareholder's interest in a corporation as the result of a transaction indicates an equity interest. MBA had no shareholders when the purchase agreement was signed, and the Bells subsequently became its sole shareholders. The transaction did not affect Mr. Bell's ownership interest. This factor was neutral.

d. **Identity of interest**. Advances made by shareholders in proportion to their stock ownership indicate a capital contribution. "A sole shareholder's advance is more likely committed to the risk of the business than an advance from a creditor who is not a shareholder." (NA General Partnership, TC Memo 2012-172) The transaction took place between MBA and Mr. Bell. The fact that Mr. and Mrs. Bell became MBA's sole shareholders indicated a capital contribution.

e. **Ability to obtain loans from other sources.** The corporation's ability to borrow funds from a third party indicates a debt. "If no reasonable creditor would have sold property to the corporation with payments to be made in the future, an inference arises that a reasonable shareholder would not do so either." (Hardman) The record contained no evidence as to whether MBA, a newly organized and thinly capitalized business, could have obtained a loan from a third party. The Tax Court believed that an arm's-length creditor would not have been willing to lend MBA $225,000 on terms and conditions similar to those in the purchase agreement. This factor weighed in favor of a finding of capital contribution.

After considering its 11 factors, the Ninth Circuit held that the Tax Court did not clearly err in concluding that the contractual right to $225,000 was properly viewed as "stock" and not "indebtedness." Thus, §351(a), not §351(b) dictated the tax treatment of the transaction. Although the transaction had many formal indicia of a sale, the substance, not the form, controls the characterization of a taxable transaction. Many factors supported the Tax Court's determination that the right to $225,000 was properly viewed as "stock:" MBA had no meaningful assets apart from the REO contracts and no history of doing business. There was no security or promissory note; MBA had very little capital and no history of repayment; and the REO contracts were speculative. It agreed with the Tax Court that no evidence suggested that MBA could have obtained a loan from a third party.

The Ninth Circuit distinguished this case from the transaction it addressed in *Gyro Engineering Corporation ,* (CA 9 1969) 24 AFTR 2d 69-5797. (1) The corporation in Gyro issued negotiable promissory notes; (2) the purchased apartments in Gyro had a history of producing income sufficient to make the payments under the notes; (3) unlike the REO contracts, the apartment buildings in Gyro had self-liquidating potential; (4) in Gyro, experts testified that the present cash value of the apartment buildings was approximately the same as the transaction amount, and (5) the government's expert in Gyro acknowledged that a hypothetical average investor would have entered into the agreement.

Under §362(a), MBA's initial basis in all of the property it received in connection with the §351(a) transaction was the same as the Bells' basis in the property. In addition to the amount MBA paid to renew the franchise license agreement, MBA assumed Mr. Bell's basis in the franchise license agreement. Since the Bells provided no evidence that they had any basis in the transferred contracts or goodwill, MBA had no basis in those items and could not depreciate or amortize them.

Observation: In 2016, IRS issued final and temporary regulations under its §385 authority, generally applicable to tax years ending after January 18, 2017, that treat certain corporate related-party ("expanded group") interests that otherwise would be treated as debt as stock for federal tax purposes and that set threshold documentation requirements needed for certain related-party interests in a corporation issued or deemed issued after December 31, 2017, to be treated as debt. The regulations restrict the ability of corporations to engage in "earnings stripping" by treating financial instruments that taxpayers purport to be debt as equity in certain circumstances. They also require corporations claiming interest deductions on related-party loans to provide documentation for them, similar to the common practice for third-party loans. Because the ability to minimize income tax liabilities through the issuance of related-party financial instruments is not limited to the cross-border context, the regulations also apply to related U.S. affiliates of a corporate group. (See T.D. 9790, 10/13/2016) These regulations have now been identified as potentially qualifying for "burden reduction" pursuant to President Trump's Executive Order 13789. (See Notice 2017-38)

Bohanec, (DC CA 12/8/2016) 118 AFTR 2d ¶ 2016-5537.

A district court has found that the taxpayers' failure to timely file a Foreign Bank and Financial Accounts Report (FBAR) was willful where, among other things, they stopped employing a bookkeeper or keeping any books after opening a foreign bank account and made several misrepresentations under penalty of perjury when they applied to participate in IRS's Offshore Voluntary Disclosure Program (OVDP).

Under the Bank Secrecy Act, U.S. citizens must file an FBAR with the U.S. Treasury disclosing any financial account in a foreign country with assets in excess of $10,000 in which they have a financial interest, or over which they have signatory or other authority. Except in the case of willful failures, the amount of any civil penalty imposed for violating this rule will not exceed $10,000. However, those who willfully fail to file their FBARs on a timely basis, i.e., on or before June 30 of the following year, can be assessed a penalty of up to the greater of $100,000 (as adjusted for inflation (31 CFR §1010.821)) or 50% of the balance in the unreported bank account for each year they fail to file a required FBAR. IRS has discretion as to the amount of the penalty, subject to these limits. (31 USC 5321(a)(5)(C))

Part III to Schedule B of the 1998 Form 1040 concerned foreign accounts and trusts. Question 7a in Part III to Form 1040, Schedule B asked: "At any time during 1998, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See page B-2 for exceptions and filing requirements for Form TD F 90-22.1."

Page B-2 of the instructions for Schedule B for 1998 stated: "See [FBAR] Form TD F 90-22.1 to find out if you are considered to have an interest in or signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)." Page B-2 of the instructions for Schedule B for 1998 also stated: "If you checked the Yes box on line 7a, file [FBAR]

Form TD F 90-22.1 by June 30, 1999, with the Department of the Treasury at the address shown on that form."

On March 26, 2009, IRS announced its first OVDP, a form of a tax amnesty program. It permitted U.S. taxpayers with unreported foreign accounts to avoid criminal charges and pay reduced civil penalties by making a voluntary disclosure to IRS. IRS has since established additional OVDPs.

The taxpayers were Mr. and Mrs. Bohanec. Mr. Bohanec owned a camera shop in California. He had two camera-related patents that he obtained without any assistance from an attorney. For many years in a row, the Bohanecs had an accountant prepare their tax returns.

The Bohanecs arranged with Leica, a German camera manufacturer, to become an exclusive Leica dealer. The camera shop was the only exclusive Leica dealer in the world. After other retailers complained about the deals the camera shop received, Leica ended the exclusivity deal and restricted the camera shop's Leica purchases.

Leica had a subsidiary in Canada called Leitz Canada, which was headed by Walter Kluck. Sometime in the late 1970s, the shop started purchasing Leica cameras from Leitz Canada and thus avoided the supply constraints imposed by Leica.

The camera shop shipped to customers around the world. During the 1980s, the Bohanecs brokered transactions between Leitz Canada and various camera retailers around the world. Kluck contacted the Bohanecs requesting their assistance in finding international buyers, for which the Bohanecs would earn a commission.

Commissions for international sales were deposited into an account at UBS AG in Switzerland in the Bohanecs' name. UBS AG is a Swiss financial-services company. Kluck opened the Swiss account on the Bohanecs' behalf. The Bohanecs did not provide UBS AG with their home address. The Bohanecs did not tell anyone in the U.S., other than their two children, of the existence of the Swiss account. By the time the Bohanecs had the Swiss account, they no longer used a bookkeeper or kept any books. The Bohanecs never discussed the Swiss account with an accountant, lawyer, or banker.

In addition to the Leitz Canada commission deposits, the Bohanecs directed their international customers, on at least a few occasions, to deposit money directly into the Swiss UBS account. The UBS account was managed by Kluck while he was alive and, thereafter, by UBS.

The Bohanecs opened other foreign bank accounts in Austria and Mexico. They made several transfers from the UBS account to these other accounts. As of June, 2008, they had a balance of almost $650,000 in the UBS account. Between the filing of their 1998 federal income tax return and May 19, 2011, the Bohanecs did not file any federal income tax returns. Between the opening of the UBS account and May 19, 2011, the Bohanecs did not file any FBARs.

On January 6, 2010, the Bohanecs executed an application to participate in the OVDP. The Bohanecs' application, submitted under penalty of perjury, represented that the "original balance and all funds deposited into the [Swiss UBS] account were after-tax earnings from our camera business." On May 19, 2011, the Bohanecs executed and filed FBARs and federal income tax returns for 2003, 2004, 2005, 2006, 2007, and 2008.

While those FBARs included the UBS account, they did not include the Austrian or Mexican accounts. The Bohanecs were ultimately rejected by IRS for the OVDP.

The Bohanecs did not report the commission income they received from Leitz Canada on their federal income tax returns. They also sold cameras on Ebay and did not report that income on their returns.

The only issue in this case was whether the Bohanecs' failure to file a 2007 FBAR was willful.

The court, rejecting the Bohanecs' argument, concluded that the term "willful" included "reckless" for purposes of FBAR.

The court first noted that 31 USC 5321(a)(5) does not define willfulness. The Bohanecs asserted that "willfulness" encompasses only intentional violations of known legal duties, and not reckless disregard of statutory duties. But the court said that no court has adopted that principle in a civil tax matter. The only cases the Bohanecs cited to support their argument that "willful" means that a defendant must have knowledge and specific intent -*Ratzlaf v. United States,* (S Ct 1994) 510 U.S. 135 (structuring) and *United States v. Eisenstein,* (CA 11 1984) 731 F.2d 1540 (felonious failure to file currency transaction reports)-were criminal cases. The Bohanecs noted that IRS Chief Counsel, in Chief Counsel Advice 200603026, has opined that the willfulness standard for purposes of 31 USC 5321 is the same as the criminal standard. But, the court said, IRS Chief Counsel Advice may not be cited as precedent.

The court said that, where willfulness is an element of civil liability, the Supreme Court generally understands the term as covering "not only knowing violations of a standard, but reckless ones as well." (*Safeco Ins. Co. of America v. Burr,* (S Ct 2007) 551 U.S. 47) "Recklessness" is an objective standard that looks to whether conduct entails "an unjustifiably high risk of harm that is either known or so obvious that it should be known." (Safeco) Several other courts, citing Safeco, have held that "willfulness" under 31 USC 5321 includes reckless disregard of a statutory duty. See *Williams,* (CA 4 2012) 110 AFTR 2d 2012-5298 and *Bussell,* (DC CA 2015) 117 AFTR 2d 2016-439.

The court then concluded that the Bohanecs' failure to timely file an FBAR for 2007 was willful.

The court first considered the issue of standard of proof. It said that the Supreme Court has held that a heightened clear and convincing burden of proof applies in civil matters "where particularly important individual interests or rights are at stake." (*Herman & MacLean v. Huddleston,* (S Ct 1983) 459 U.S. 375) Such interests include parental rights, involuntary commitment, and deportation. The lower, more generally applicable preponderance of the evidence standard applies, however, where "even severe civil sanctions that do not implicate such interests" are contemplated. (Herman) The court here said that the monetary sanctions at issue here did not rise to the level of "particularly important individual interests or rights." Accordingly, the court said, the preponderance of the evidence standard applied.

It then concluded that IRS proved by a preponderance of the evidence that the Bohanecs were at least recklessly indifferent to a statutory duty, for the following reasons:

a. The Bohanecs were reasonably sophisticated businesspeople. For a time, the Bohanecs' camera shop was the only exclusive Leica dealer in the world. The deals the Bohanecs negotiated with Leica's U.S. distributor were so favorable as to motivate other Leica retailers to protest. The Bohanecs were able to circumvent Leica's supply restrictions by entering into an international agreement with Leitz Canada. The Bohanecs had a worldwide reputation and sold and shipped to customers around the world.

b. The Bohanecs were at least reckless, if not willfully blind, in their conduct with respect to their Swiss UBS account and their reporting obligations regarding the account. The Bohanecs never provided UBS with their home address, and never told anyone other than their children of the existence of the UBS account, including the tax preparers the Bohanecs hired to help them file tax returns. The Bohanecs never asked a lawyer, accountant, or banker about requirements regarding the UBS account and never used a bookkeeper or kept any books once the UBS account was opened.

c. The Bohanecs' representations that they were unaware of or did not understand their obligations, and deferred entirely to Kluck, were not credible. Part III of Schedule B of the Bohanecs' 1998 tax return put them on notice that they needed to file an FBAR. The Bohanecs not only deposited commissions from their Leitz Canada deals into the UBS account but also directed customers to deposit payment into the account and made several transfers and withdrawals from the UBS account to other foreign accounts.

d The Bohanecs' credibility was further undermined by their conduct with respect to their application to participate in the OVDP. The Bohanecs made several misrepresentations under penalty of perjury. They misrepresented, for example, that all of the funds in the UBS account were after-tax proceeds from the Bohanecs' camera business, when the account included Leitz Canada commissions that had never been reported on income tax returns. The application also failed to disclose the Bohanecs' Austrian and Mexican bank accounts.

Boneparte, TC Memo 2017-193

Taxpayer who worked as a tunnel bridge agent during the day was not a professional gambler even though he spent a large percentage of his nights gambling in Atlantic City, New Jersey casino hotels.

§162(a) allows deductions for ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. If a taxpayer is engaged in the trade or business of gambling, his losses from gambling, up to the amounts of his gains from such transactions, are deductible in arriving at his adjusted gross income. (§62(a)(1), §165(d)) Individuals not engaged in the gambling business deduct gambling losses (to extent of gambling gains) only as miscellaneous itemized deductions. (*Torpie*, TC Memo 2000-168)

To be a professional gambler, the taxpayer must be engaged in gambling with the objective of making a profit. (§183(a), §183(b), §183(c)) Although a reasonable expectation of profit is not required, the taxpayer's profit objective must be actual and honest. (Regulation §1.183-2(a))

The regulations set forth a nonexhaustive list of factors to be considered in deciding whether a profit objective exists. These factors include: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisers; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) the elements of personal pleasure or recreation. (Regulation §1.183-2(b)) No single factor or group of factors is determinative. (*Golanty*, (1979) 72 TC 411)

The taxpayer, Mr. Boneparte, was employed full time as a tunnel bridge agent by the Port Authority of New York and New Jersey (Port Authority) and worked a 2

p.m. to 10 p.m. shift there. For tax year 2012, he spent 33% to 50% of his nights in Atlantic City and for tax year 2013, he spent 50% to 67% of his nights there.
He gambled in casinos, principally at unskilled games of chance such as baccarat and slots, and at horse racetracks. He did not keep a contemporaneous written log of wins and losses for his gambling activities. The casinos he frequented provided him with annual statements but most of these showed only the total amount that Boneparte gained or lost during the year.

On his 2012 and 2013 tax returns, Boneparte reported his income and loss from gambling activity both as a professional gambler (on Schedule C) and as a casual gambler (on line 21 of Form 1040) and line 28 of Schedule A). For example, for 2012, on Schedule C he claimed professional gambler income of $18,000 and a loss of $89,116 after claiming expenses such as travel, meals and entertainment, and car and truck expenses. On line 21 of Form 1040, he reported $18,000 of gambling income, and on Schedule A, line 28, he claimed an $18,000 deduction for “gambling income.”

Court rules that taxpayer was not professional gambler. The Tax Court looked at the Regulation §1.183-2(b) factors for whether Boneparte had a profit objective and determined that he failed to satisfy any relevant factors and thus was not a professional gambler. Here are a few of the factors that the Court discussed:

1. **Manner in which the taxpayer carries on the activity.** The fact that a taxpayer carries on the activity in a businesslike manner, and maintains complete and accurate books and records, may indicate a profit motive. (Regulation §1.183-2(b)(1)) Boneparte did not maintain complete and accurate records of his gambling activity, other than the win/loss statements provided by the casinos he frequented. These statements generally only listed the aggregate amount he won or lost during a year. Accordingly, he did not carry on his gambling activity in a businesslike manner.

2. **Expertise of the taxpayer or his advisers.** Preparation for the activity by extensive study of its accepted business practices, or consultation with those who are expert therein, may indicate a profit objective where the taxpayer carries on the activity in accordance with such practices. (Regulation §1.183-2(b)(2)) Boneparte testified that he spent time with a friend who also gambled frequently. He said that this friend helped him learn about gambling. Boneparte also testified that he purchased books and videos on how to win playing slot machines and baccarat. The Tax Court said Boneparte's testimony was credible, but the mere fact that he tried to learn how to win at slot machines and baccarat did not necessarily suggest that he played these games in order to make a profit. It was also consistent with playing the games for recreation or, alternatively, trying to limit his losses.

3. **Time and effort devoted to an activity.** These factors may indicate a profit motive, particularly if the activity does not include substantial recreational aspects. A taxpayer's withdrawal from another occupation to devote most of his or her energies to the activity may be evidence that the activity is engaged in for profit. (Regulation §1.183-2(b)(3)) Boneparte's primary activity was working full-time as a “tunnel bridge agent” with the Port Authority. Although he gambled frequently, he gambled only in

his spare time. Furthermore, he derived a recreational benefit from his gambling activity. This was why he continued to gamble despite the lack of profit.

4. **History of income or loss with respect to the activity**. A series of years of net income would be a strong indication that the activity is engaged in for profit. By contrast, year after year of losses may indicate a lack of profit motive. (Regulation §1.183-2(b)(6)) Boneparte has a history of gambling losses and never profited from gambling.

5. **Taxpayer's success in carrying on other similar or dissimilar activities**. The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that the activity in question was engaged in for profit, even though the activity is presently unprofitable. (Regulation §1.183-2(b)(5)) Boneparte provided no evidence of history of success with business activities other than working as a tunnel bridge agent. The Tax Court dryly noted that such employment was “not necessarily helpful in preparing someone for a successful career as a gambler.”

Observa**tion:** This is the second time that Boneparte lost on the professional gambler issue (see *Boneparte,* TC Memo 2015-128).

Bon Viso, TC Memo 2017-154.

An individual had to include in his gross income the full amount of his gambling winnings, as reflected on his Forms W-2G (Certain Gambling Winnings), without any reduction for the amount he bet to achieve those winnings. Further, the individual, who was not engaged in the trade or business of gambling, could only deduct his gambling losses as a miscellaneous itemized deduction if he chose to forgo the standard deduction.

Under §61(a), gross income is defined to mean all income from whatever source derived. Gambling winnings are includable in gross income. (*McClanahan v. U.S.* (CA 5 1961) 8 AFTR 2d 5077) Drawing an analogy between gambling winnings and the recovery of a capital investment, a casual gambler's gross income from a wagering transaction should be calculated by subtracting the bets placed to produce the winnings. (*Lutz*, TC Memo 2002-89, *Hochman,* TC Memo 1986-24)

An individual's taxable income generally is computed by subtracting from his adjusted gross income: (1) the deduction for personal exemptions; and (2) either (a) the standard deduction, or (b) if he elects to itemize, the individual's itemized deductions. (§63(b))

§162(a) allows deductions for ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. If a taxpayer is engaged in the trade or business of gambling, his losses from gambling, up to the amounts of his gains from such transactions, are deductible in arriving at his adjusted gross income. (§662(a)(1), §165(d)) Individuals not engaged in the gambling business deduct gambling losses (to extent of gambling gains) only as miscellaneous itemized deductions. (*Torpie,* TC Memo 2000-168)

Under the so-called "Cohan rule," if a taxpayer establishes that an expense is deductible, but is unable to substantiate the precise amount, a court may estimate the amount, bearing heavily against the taxpayer whose inexactitude is of his own making. The taxpayer must present sufficient evidence for a court to form an estimate. (*Cohan v. Commissioner,* (CA 2 1930) 8 AFTR 10552)

During 2013, William Bon Viso engaged in a variety of recreational gambling activities but was not in the trade or business of gambling. He bet on college and professional sports, played slot machines, and bought lottery tickets. That year, he won $5,060 on slot machines at three different casinos, but also sustained $6,983 in gambling losses.

On his 2013 return, the taxpayer claimed a standard deduction of $12,200. He did not report any gambling winnings or losses for the 2013 tax year.

Based on three Forms W-2G, which reported totaling winning of $5,060 for Mr. Bon Viso, IRS issued a notice of deficiency in which it determined that he had $5,060 of unreported gambling income for 2013.

While he did not challenge the accuracy of the gross winnings amounts reflected on the Forms W-2G, Mr. Bon Viso argued that the amounts should be reduced by the amounts of bets he placed to produce the $5,060 winnings. He also argued that he should be able to use his gambling losses to offset his gambling winnings.

The Tax Court held that the taxpayer had to include his full $5,060 gambling winnings in his gross income for 2013. The Court also concluded that, as Mr. Bon Viso was not engaged in the trade or business of gambling, he could only deduct his gambling losses (to extent of gambling gains) if he elected to deduct his miscellaneous itemized deductions instead of taking the standard deduction.

The Court noted that although Mr. Bon Viso introduced evidence of losses at another casino (in addition to lottery tickets and sporting bets), he provided no evidence specifying how much he bet to produce the winnings reflected on the Forms W-2G. While the Court can estimate the amount of a reduction in income under the Cohan rule, even if the taxpayer failed to keep records, it can only do so if the taxpayer presents sufficient evidence to establish a rational basis for making the estimate. Here, since the Tax Court had no basis for estimating the amounts Mr. Bon Viso's bets, it held that he had to include the full $5,060 of gambling winnings in his gross income.

In addition, the Court found that Mr. Bon Viso would have to forgo the standard deduction to deduct his gambling losses as an itemized deduction. Since Mr. Bon Viso's standard deduction of $12,200 exceeded his potential itemized deduction for gambling losses, his election to take the standard deduction resulted in a larger deduction than if he had taken an itemized deduction for his gambling losses. Because he elected to take the standard deduction, the Court determined that Mr. Bon Viso could not take an itemized deduction for his gambling losses to offset his gambling winnings.

Brown, TC Memo 2017-18.

The taxpayers' former S corporation could not deduct salary and wage expenses and pass through the loss to the taxpayers. The court found the amounts could not be deducted because the S corporation was not engaged in a trade or business and was not in existence for the year at issue. Moreover, the S corporation was not the taxpayer that made the expenditures and the payment was a nondeductible trust fund recovery penalty that had been assessed against the taxpayers.

Under §162(a), a taxpayer can deduct all the ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business. However, §162(f) prohibits a deduction under §162(a) for any fine or similar penalty paid to a government for the violation of any law.

§6672 imposes a trust fund recovery payment on any person who: (1) is responsible for collecting, accounting for, and paying over payroll taxes; and (2) willfully fails to perform this responsibility. The amount of the penalty is equal to the amount of the tax that was not collected and paid.

Philip Brown and his wife, Amber Brown, held 100% of the membership interests in Quantum Group, LLC (Quantum LLC) until 2012, when the company added two additional members, and the taxpayers' interests were reduced to 87.5%.

The Browns also owned 100% of a separate S corporation, Quantum Inc. During the 2000 through 2002 tax years, Quantum Inc. accumulated unpaid payroll tax liabilities, for which trust fund recovery penalties were subsequently assessed against the Browns.

Quantum Inc. did not file any tax returns from 2003 through 2011. It was administratively dissolved by Arizona on November 26, 2007 for failure to file an annual report. Quantum Inc. was not registered as an active entity with any State during 2012, and did not provide any services or generate any income during 2012.

In 2012, Quantum LLC sent $215,000 from its bank account to the trust account of the Browns' attorney, who then sent a certified check in that amount to IRS with a letter that stated, in part:

"Enclosed please find payment in the amount of $215,000.00 for payment of Employee Withholding Amounts i.e. Trust Fund Taxes (amounts eligible for Trust Fund Recovery Penalty) for Quantum Group, Inc. EIN [redacted] for the periods 12-31-2000, 3/31/2001, 06/31/2001, 09/31/2001, 12/31/2001, 03/31/2002. The enclosed amount is hereby directed to be applied to only the Employee Withholding Amounts i.e. Trust Fund Taxes (amounts eligible for Trust Fund Recovery Penalty) portion of the employment taxes due for the above periods."

The accompanying letter further stated:

"This amount cannot be applied by the Internal Revenue Service to any amount due for Employee Withholding Amounts i.e. Trust Fund Taxes (amounts eligible for Trust Fund Recovery Penalty) for Quantum Group, Inc. EIN [redacted] for the periods 12-31-2000, 3/31/2001, 06/31/2001, 09/31/2001, 12/31/2001, 03/31/2002 except those amounts and applicable accrued interest for which the Shareholders of Quantum Group, Inc. have previously been determined to be liable pursuant to the Trust Fund Recovery Penalty (TFRP) procedures of the Internal Revenue Service for the above identified periods."

Quantum Inc. filed a tax return for 2012, indicating that it was a cash basis taxpayer and showing no assets, income, or other tax items, with the exception of a deduction of $180,911 for salaries and wages. This deduction was passed through to the Browns as an ordinary business loss. Quantum Inc. did not pay any salaries or wages in 2012, nor did it have any bank accounts at any point in 2012.

IRS disallowed Quantum Inc.'s $180,911 deduction. This disallowance was reflected in adjustments to the taxpayers' Schedule E (Supplemental Income and Loss), resulting in the disallowance of the taxpayers' corresponding $180,911 loss.

The taxpayers' argued that the payment of the outstanding liabilities was deductible by Quantum Inc. as an amount representing the employees' portion of payroll tax withholding, which was deductible by the corporation as an ordinary and necessary business expense. The Browns also noted that the employment tax ostensibly paid by Quantum Inc. was not a trust fund recovery penalty because Quantum Inc. did not owe a trust fund recovery penalty. They further contended that the payment of employment taxes by a corporation was a deductible expense regardless of the fact that an owner of the corporation may get a secondary benefit from the payment of the taxes.

On the other hand, IRS argued that the salaries and wages expense reported by Quantum Inc. was nondeductible because (1) the company did not incur or pay any expenses in 2012 while carrying on a trade or business; and (2) the expense was a nondeductible trust fund recovery penalty.

The Tax Court found that Quantum Inc. could not deduct the payroll tax payment made in 2012 ostensibly on its behalf, because the corporation was not in existence at the time. The Court further held that even if Quantum Inc. did exist in 2012, it could not have deducted the sum, because it had not actually paid the amount. In addition, the taxpayers failed to satisfactorily demonstrate that the payment was for anything other than their trust fund recovery liability, which was nondeductible under §162(f).

In reaching its conclusion, the Tax Court determined that Quantum Inc. was not engaged in any activity during 2012: it had no assets or income, nor did it have any customers or perform any services. The Court was not persuaded by the taxpayers' argument that the act of filing a tax return proved that Quantum Inc. was carrying on a trade or business. However, the Court found that a cash basis taxpayer could deduct ordinary and necessary business expenses, the liability for which arose in the active conduct of a trade or business, even if the payment was made after the termination of that business. (See Revenue Ruling 67-12, 1967-1 CB 29.) Thus, it reasoned that if the $215,000 payment was made to settle Quantum Inc.'s payroll tax liabilities from its prior conduct of a trade or business, then the lack of a present trade or business was not necessarily an obstacle, if Quantum Inc. was still in existence in 2012.

But, Quantum Inc. had not filed any returns after 2002 (with the exception of the 2012 return) and was dissolved in 2007, and the Browns presented no evidence that it had any assets or engaged in any activities after 2002. Accordingly, the Court found that Quantum Inc. did not exist in corporate form in 2012, and for that reason it could not properly have filed the 2012 return or claimed the deduction.

The Tax Court further reasoned that even if Quantum Inc. was not defunct in 2012 and could have filed a return and claimed deductions, it could not deduct the $180,911 payment to IRS because it did not actually pay that amount. Under the cash accounting method, as a general rule, amounts representing allowable deductions must be taken into account for the tax year in which paid. Thus, for a corporation to be able to deduct expenses under §162, it must have paid the amount at issue in 2012. Quantum Inc. did not do so.

Rather, Quantum LLC, an unrelated entity, disbursed the $215,000 to the Browns' attorney, who subsequently directed that money to IRS with an accompanying letter stating that the amount was in satisfaction of "those amounts and applicable accrued interest for which the Shareholders of Quantum Group, Inc. have previously been determined to be liable pursuant to the Trust Fund Recovery Penalty (TFRP) procedures of the Internal Revenue Service." Quantum Inc. did not have a bank account into which the $215,000 was deposited, nor was there any evidence that the corporation at any point held title to the money. While the Browns claimed that they had contributed money to Quantum Inc., which then used the sum to pay its alleged outstanding payroll tax liabilities, the Browns had not presented evidence to corroborate this assertion. All the record showed was a distribution from Quantum LLC that was deposited into the Browns' attorney's trust account, from which it was sent to IRS, bypassing Quantum Inc. entirely. The certified check from the taxpayers' attorney stating that the $215,000 payment was "on behalf of Quantum Group, Inc." also failed to establish that Quantum Inc. was the actual payer of the sum. When it comes to a taxpayer deducting expenses under §162, the Court reasoned that a payment on behalf of that taxpayer by another was not the same as a payment made by the taxpayer itself.

The Tax Court determined that the most plausible meaning of the attorney's letter was that Quantum Inc. purported to voluntarily pay the trust fund recovery penalty on behalf of the Browns-something that, under §162(f), would not entitle the corporation to a deduction. The Court found that even if the Browns had contributed the $215,000 amount to Quantum Inc. and the corporation still existed at the time, the Browns nonetheless failed to show that the sum was for anything other than their trust fund recovery liability. The taxpayers' potentially strongest evidence-their attorney's letter accompanying the certified check sent to IRS-was opaquely worded, but the Court concluded that it could not ignore the letter's repeated references to "amounts eligible for Trust Fund Recovery Penalty" and its express limitation to "those amounts and applicable accrued interest for which the Shareholders of Quantum Group, Inc. have previously been determined to be liable pursuant to the Trust Fund Recovery Penalty (TFRP) procedures."

Bulakites, TC Memo 2017-79.

The Tax Court has denied most of a taxpayer's deductions for alimony, interest expenses, and net operating loss (NOL) carryovers and rejected his attempt to avoid accuracy-related penalties by blaming these improper deductions on his TurboTax return preparation software.

Under §215(a), a taxpayer is allowed a deduction for the amount of alimony he or she paid. §71(b) provides that the payment must be required by a divorce or separation instrument. A divorce or separation instrument is a decree of divorce or separate maintenance or a written instrument incident to such a decree; a written separation agreement; or a decree requiring a spouse to make such payments. (§71(b)(2))

Under §162(a), a taxpayer may deduct interest paid or incurred during the tax year if the interest is an ordinary and necessary expense of carrying on his trade or business. To be deductible, a taxpayer must be able to substantiate that interest. Among other things, this means that the taxpayer must show that he made a payment and show what portion was interest and what portion was repayment of principal. (*Porter*, TC Memo 2015-122)

§172 allows a deduction for NOL carryovers from earlier years, and NOL carrybacks from later years as long as the taxable income for the current year is greater than zero. (§172(a), §172(b)(2)) A taxpayer substantiates his or her claim to the deduction by filing with his return "a concise statement setting forth the amount of the net operating loss deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the net operating loss deduction." (Regulation §1.172-1(c))

§6662 imposes a penalty on the taxpayer when there is a substantial understatement of income tax. (§6662(b)(2)) An understatement of tax is "substantial" if it exceeds the greater of $5,000 or 10% of the tax required to be shown on the return. (§6662(d)(1)(A)) But, under §6664(c)(1), an accuracy-related penalty under §6662 will generally not apply to any portion of an underpayment if it is shown that there was reasonable cause for that portion and that the taxpayer acted in good faith; (*U.S. v. Boyle,* (S Ct 1985) 55 AFTR 2d 85-1535)

In 2007, Barry Bulakites, a specialist in life insurance and annuities, paid a settlement in a business-related lawsuit by taking out a $500,000 one-year loan secured by his home. (The promissory note he gave did not reflect what the money was to be used for, and at trial he did not introduce any additional records to explain this.) His intention was to sell his home and use the proceeds to pay the note, but the 2008 recession intervened. By 2009, the real estate market had not improved, and he was still unable to sell his home.

In 2009, he and his then-wife legally separated, and, a year later, divorced. Their separation agreement directed Bulakites to pay his ex-wife $2,000 per month for spousal support until the sale of the marital residence, at which point his payments were to increase to $8,000. In an effort to do "the right thing," Bulakites orally agreed with his ex-wife to increase his payments to $5,000 per month.

On his return for 2011 and 2012, Bulakites claimed alimony and interest expense deductions related to the note. On his 2011 return, he also claimed a NOL carryover from an earlier year.

On audit, IRS challenged these deductions and assessed §6662 accuracy-related penalties for the years at issue.

The Tax Court found that while Bulakites did not quite keep up with the promised $5,000 a month payment schedule, the documents in the record showed that he paid his ex-wife about $50,000 in both 2011 and 2012. However, the Court denied Bulakites' alimony expense in excess of the $2,000 a month required by his separation agreement. The Court determined that it was well-settled that an oral modification of a written instrument did not meet §71 's requirements. (*Gordon,* (1978) 70 TC 525) While the Court found his motivation sincere, the Code did not allow him to deduct the excess amounts he paid as alimony.

The Court disallowed all Bulakites' interest expense deductions. Although the evidence showed that he made payments to his lender, the amounts did not match those that he claimed on his tax returns, and he did not explain this discrepancy at trial. Bulakites did not provide any business records regarding the loan, any loan statements, or any loan repayment schedules. Without this type of documentation, the Court was unable to tell whether or not these payments were made on the original 2007 loan. Without any paperwork (in a situation where there should have been lots of paperwork), the Court was left only with his testimony about the total amounts of the payments and the allocation of those payments between principal and interest. Without more, the Court could not figure out what happened to the notes which should have been paid in full by October 2008.

The Tax Court denied Bulakites' NOL deductions, finding that he failed to substantiate them. He provided none of the documentation required under Regulation §1.172-1(c). During trial he did turn in a tax return for a previous year (though not the one that generated the NOL), but even with his testimony, that was not enough to substantiate his entitlement to a loss carryforward.

The Court also upheld IRS's imposition of accuracy-related penalties. Bulakites' understatements for the 2011 and 2012 tax years well surpassed both $5,000 and 10% of the tax required. And, he failed to show that his mistakes were reasonable and in good faith under §6664(c)(1). He admitted during trial that he deducted items he should not have and that he overstated certain losses. The Court was not persuaded by his attempt to blame the TurboTax software for luring him into claiming improper deduction. The Court, citing *Bunney,* (2000) 114 TC 259, noted that "[t]ax preparation software is only as good as the information one inputs into it."

Burnett AOD 2017-01, 2/13/2017.

IRS has announced its nonacquiescence with the decision of the Court of Appeals for the Fifth Circuit in Burnett that the active-participation exception to a partnership being classified as a farming syndicate could be met by an individual who actively participated and owned a super-majority interest in a farming partnership through her wholly owned S corporation. The decision allowed the partnership to avoid otherwise mandatory use of the accrual accounting method.

Observation: Congress moved the definition of a farming syndicate from former §464(c) to the end of §461 and redesignated those rules as §461(j), although no substantive change in the provision was made. The redesignation appears to be a drafting error because the rules relating to the disallowance of excess farm losses were already provided in §461(j), and the definition of a farming syndicate should have been numbered as §461(k). Presumably, Congress will correct this drafting error in a future technical correction.

A farming syndicate is a tax shelter arrangement by which a farmer with tax losses sells a partnership interest in the farm to a high-income individual taxpayer who has no genuine interest in farming, with the purpose of providing the taxpayer loss deductions on his federal income-tax return. (*Estate of Wallace v. C.I.R.*, (CA 11 1992) 70 AFTR 2d 92-5349)

Under §461(k)(1)(B); former §464(c)(1)(B)], a farming syndicate is defined as "a partnership or any other enterprise other than a corporation which is not an S corporation engaged in the trade or business of farming, if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs" (i.e., persons who have an interest in an enterprise other than as a limited partner, and do not actively participate in the management of the enterprise).

§461(k)(2); former §464(c)(2)] provides that

"For purposes of paragraph (1)(B) [i.e., §461(j)(1)(B), above], the following shall be treated as an interest which is not held by a limited partner or a limited entrepreneur:"

"(A) in the case of any individual who has actively participated (for a period of not less than five years) in the management of any trade or business of farming, any interest in a partnership or other enterprise that is attributable to such active participation," (§461(j)(2)(A) [sic. §461(k)(2)(A); former §464(c)(2)(A)])

Thus, when computing the amount of partnership losses that are allocable to limited partners for purposes of §461, any interest in the partnership that is "attributable to" an individual's 5-plus years of active participation in the management of a farming business must be excluded (the active-participation exception).

§448(a)(3) generally provides that a tax shelter cannot use the cash receipts and disbursement method of accounting (cash accounting method). For this purpose, a syndicate is considered a tax shelter. (§461(i)(3)(B))

Burnett Ranches, Ltd (the Partnership) was a limited partnership engaged in the business of farming. Burnett Ranches, Inc. was a subchapter S corporation (the S Corporation) that owned an 85.52% limited partnership interest in the Partnership in 2005 and a 99% limited partnership interest in 2006 and 2007. The S Corporation did not independently carry on a farming business. An individual was the sole owner of the S Corporation during 2005, 2006, and 2007.

The Partnership used the cash accounting method in 2005, 2006, and 2007. IRS determined that the Partnership was a farming syndicate required to use an accrual accounting method and issued a notice of final partnership administrative adjustment. The Partnership sought relief in the district court.

The district court found that the active-participation exception in §461(j)(2)(A) [sic. §461(k)(2)(A); former §464(c)(2)(A)] applies to any interest that is attributable to an individual's 5-plus years of active participation in ranch management, meaning that the exception was not limited solely to interests held by individuals. (*Burnett Ranches, Ltd. v. U.S.*, (DC TX 10/24/2013) 113 AFTR 2d 2014-2183)

After an exhaustive statutory analysis, the Fifth Circuit, affirming the district court, concluded that an otherwise qualified individual who has participated in management of the farming operations for not less than five years comes within the active-participation exception in §461(j)(2)(A) [sic. §461(k)(2)(A); former §464(c)(2)(A)], irrespective of the fact that the legal title of the individual's attributable interest happens to be held in the name of the taxpayer's wholly owned S corporation rather than in the taxpayer's own name.

The Fifth Circuit concluded that the partnership was excluded from the definition of a farming syndicate based on its expansive interpretation of the reference in to "any interest." The Court interpreted the meaning of interest "in the broader dictionary sense of involvement with or participation in something; a right, claim, or share in something; or 'something in which such a right, claim, or share is held,'" including "the fact or relation of having a share or concern in, or a right to, something...A thing which is to the advantage of someone."

IRS announced that it does not acquiesce in the Fifth Circuit's Burnett decision. Accordingly, while IRS will follow the decision in cases appealable to the Fifth Circuit, it will generally not follow the decision in cases involving taxpayers outside of the Fifth Circuit.

IRS found that the Fifth Circuit's interpretation overlooked the specific context of the use of the word "interest" in §461(j)(2)(A) [sic. §461(k)(2)(A); former §464(c)(2)(A)]. The reference to "any interest in a partnership or other enterprise," together with the reference in the preceding sentence to an interest "not held by a limited partner or limited entrepreneur," clearly contemplates an "interest" in the sense of a legal property interest in a partnership (or other enterprise)-a narrower concept than the generic dictionary definition relied upon by the Court. Further, by modifying the phrase "any interest in a partnership" with the phrase "in the case of any individual," the plain meaning of the statute is that the interest must be an interest held by an individual. This narrower reading of the statute was also consistent with the legislative history which provides: "The provision specifies four cases where an individual's activity with respect to a farm will result in his not being treated as a limited partner," including "where an individual... has an interest attributable to his active participation." (H.R. Conf. Rep. No. 94-1515 at 413-415 (1976)) IRS also found support in the Staff of the Joint Commissioner on Taxation, General Explanation of the Tax Reform Act of 1976, 94th Cong., Pub. L. 94-455, at 46-48 (1976).

IRS concluded that the Fifth Circuit's holding effectively allows the Partnership to recharacterize the form of its ownership to ignore the legal existence of the S Corporation. Unlike a disregarded entity, such as a disregarded single-member limited liability company, an S corporation is treated by the Code as an entity separate from its owner or owners. In this case, the Code excludes a partnership interest of "any individual" who meets the active participation requirement. The Code does not exclude a partnership interest held by an S corporation, even if the S corporation is owned by an individual who has actively participated.

In addition, in explaining why the exception in §461(j)(2)(A) [sic. §461(k)(2)(A); former §464(c)(2)(A)] applied, the Fifth Circuit stated that Congress "expressly eliminate[d] an S corporation from the types of legal entities which that subsection subjects to farming syndicate status." But IRS concluded that this statement reflected a misunderstanding by the Court of the statutory framework: by excluding an entity "other than a corporation which is not an S corporation," §461(j)(1)(B) [sic. §461(k)(1)(B); former §464(c)(1)(B)] eliminates C corporations from the scope of the subsection, not S corporations. IRS noted that §1361(a)(2) uses similar language in the definition of a C corporation.

Camara, (2017) 149 TC No. 13

The Tax Court, reversing its holding in previous similar cases and following the reasoning of two Circuit Courts, has held that where a married person files a return with a single filing status, he has not filed a "separate return" for purposes of §6013(b) . That provision allows the filing of a joint return for a tax year after the initial filing of a separate return for that year only if certain requirements are met.

§6013(b) permits married taxpayers to elect in certain circumstances to switch from a "separate return" to a joint return. §6013(b)(2) lists limitations on this election to switch to a joint return. §6013(b)(2)(A) bars the §6013(b) election after three years from the filing deadline (without extensions) for filing the return for that year. §6013(b)(2)(B) bars the §6013(b) election "after there has been mailed to either spouse, with respect to such ta x year, a notice of deficiency...if the spouse, as to such notice, files a petition with the Tax Court within [90 days]."

The taxpayer, Mr. Camara, was married to Ms. Jatta at the end of 2012. He erroneously filed his 2012 return showing single status. IRS issued a notice of deficiency to Mr. Camara. Mr. Camara and his wife timely petitioned the Tax Court with respect to this notice on May 9, 2015. On May 27, 2016, Mr. Camara and Ms. Jatta filed with IRS a joint 2012 return.

IRS contended that Camara's original 2012 single return was a "separate return" such that the limitations of §6013(b)(2)(A) and §6013(b)(2)(B) applied to prevent the couple from filing a joint return.

The Tax Court held that a single return is not a "separate return" for purposes of §6013(b) and that therefore the taxpayers could file a joint 2012 return.

The Court noted that there have been several Memorandum Opinions of the Tax Court that have interpreted "separate return" to include a single return or a head of household return for this purpose. It noted that "the ultimate authority for these Memorandum Opinions appears to be traceable to earlier cases where the effect of an erroneous claim of filing status was neither addressed nor even presented as an issue." It also noted that one of those cases had been reversed by the Eighth Circuit *(Ibrahim, (CA 8 2015) 115 AFTR 2d 2015-2126)* and that, in another case (*Glaze, (CA 5 1981) 47 AFTR 2d 81-1224),* the Fifth Circuit held that a single return is not a "separate return" for purposes of §6013(b) . The Court also noted that the Sixth Circuit, the circuit to which this case would be appealable, has not decided the precise issue in this case.

The Tax Court said that the term "separate return" in §6013(b)(1) is not defined in the Code or the regs. It said that, considering the context of §6013(b) as a whole, and giving due regard to the Courts of Appeals' opinions in Ibrahim and Glaze, it concluded that "separate return" means a return on which a married taxpayer has claimed the permissible status of married filing separately, rather than a return on which a married taxpayer has claimed a filing status not properly available to him or her.

The Tax Court reached this conclusion for two related reasons. First, §6013(b)(1) describes filing a separate return as an "election," and the Tax Court agreed with the Courts of Appeals in Ibrahim and Glaze that filing a return with an erroneous claim to an impermissible filing status does not constitute an "election" for this purpose. And second, the legislative history shows that §6013(b)(1) was intended only to provide taxpayers flexibility in switching from a proper (though perhaps improvident) initial election to file a separate return to an election to file a joint return; it was not intended to foreclose correction of an erroneous initial return.

The Tax Court said that the term "election" embodies the notion of choice. There is no valid "choice" embodied in a return on which the taxpayer has erroneously indicated a filing status that is not legally available to him or her.

IRS also argued that because it is generally not permitted to send another notice of deficiency to a taxpayer if the taxpayer has filed a petition with the Tax Court, see §6212(c)(1) , a taxpayer should also be precluded from "filing a joint return" once he or she has filed a petition. But, the Court said, other than "its vague argument that there is some relationship between sending a notice of deficiency and making a joint return," IRS did not contend that there is any impediment-other than the §6013(b)(2) limitation, which the Court held is inapplicable-to giving a taxpayer such as Mr. Camara the benefit of joint filing status and tax rates. Consequently, IRS's argument failed.

Castigliola, TC Memo 2017-62.

While neither the Code nor any regulatory authority define "limited partner" for purposes of the §1402(a)(13) rule that excludes certain partnership income earned by limited partners from the self-employment tax base, under the ordinary meaning of the term "limited partner," the taxpayers-attorneys who were members of a professional limited liability company (PLLC)-were not limited partners under §1402(a)(13). The Court also held that unidentified moneys in the PLLC's attorney trust account were not partnership taxable income.

In general, a partner must include his distributive share of partnership income in calculating his net earnings from self-employment, for purposes of the self-employment tax.

Under §1402(a), a partner's net earnings from self-employment are generally his distributive share of the partnership's taxable income arising out of the trade or business of the partnership plus his guaranteed payments. There are several exclusions from the general self-employment tax rule. In particular, §1402(a)(13) provides that the distributive share of any item of income or loss of a limited partner is excluded. This exclusion does not apply to guaranteed payments to that partner for services actually rendered to or on behalf of the partnership, to the extent the payments are established to be remuneration for those services.

The taxpayers, Mr. Castigliola, Mr. Banahan, and Mr. Mullen, were Mississippi attorneys. They practiced as a PLLC. In 2005 the PLLC's office and many of its records were destroyed in Hurricane Katrina, but the taxpayers recovered and continued their practice.

The taxpayers were members of the PLLC; the PLLC was member-managed. The PLLC never had a written operating agreement. The members divided up the management duties, with each having significant management duties.

The members' compensation agreement required guaranteed payments to each member; the guaranteed payments were commensurate with local legal salaries. Any net profits of the PLLC in excess of amounts paid out as guaranteed payments were distributed among the members in accordance with the members' agreement.

The PLLC maintained a lawyer's trust fund account in compliance with Mississippi law. The majority of transactions in the account involved the PLLC's work in obtaining subrogation payments for its client State Farm Insurance -the PLLC collected money from uninsured individuals involved in automobile accidents with State Farm policyholders, and then periodically transferred a portion of the funds to State Farm and a portion to the PLLC's regular bank account. At the end of 2010 the trust account held $15,167 of undistributed funds; the members did not know to whom this amount belonged.

IRS issued notices of deficiency in which it found that all of the members' 2008-2010 income from the PLLC was subject to self-employment tax and that the monies in the trust fund at the end of 2010 was taxable income to the PLLC.

The Court held that none of the partners were limited partners for purposes of §1402(a)(13) and that therefore their full shares of PLLC income were subject to self-employment tax.

The Court first noted that previously, in *Renkemeyer, Campbell & Weaver,* LLP, (2011) 136 TC 137), the Tax Court had stated that no statutory or regulatory authority defines limited partner for the purposes of §1402(a)(13). The Court then said that, because the term is not defined, it would apply accepted principles of statutory construction to ascertain congressional intent and that it is a well-established rule of construction that if a statute does not define a term, the term is to be given its ordinary meaning at the time of enactment.
Renkemeyer also indicated that the meaning of "limited partner" in §1402(a)(13) is not necessarily confined solely to the limited partnership context. As a result, the Court said that it then had to consider whether any person claiming the §1402(a)(13) exemption held a position in an entity treated as a partnership for Federal tax purposes that is functionally equivalent to that of a limited partner in a limited partnership. The taxpayers were all members of a member-managed PLLC. Consequently, the issue was whether a member of such a PLLC is functionally equivalent to a limited partner in a limited partnership.

Citing a legal treatise and case law, the Court said that a limited partnership has two classes of partners, general and limited. General partners typically have management power and unlimited personal liability. On the other hand, limited partners typically lack management power but enjoy immunity from liability for debts of the partnership.

The Court then considered the Uniform Limited Partnership Act in 1916, the Revised Uniform Limited Partnership Act in 1976, and Mississippi's limited partnership law. Each of these sources provided language to the effect that a limited partner would lose limited liability protection if "in addition to the exercise of his rights and powers as a limited partner, he participates in the control of the business."

The respective interests in the PLLC held by the taxpayers made each a member of the PLLC, which was member-managed. Therefore, management power over the business of the PLLC was vested in each of them through the interest each held. The PLLC had no written operating agreement, nor was there any evidence to show that any member's management power was limited in any way. Furthermore, all members participated in control of the PLLC. For example, they all participated in collectively making decisions regarding their distributive shares, borrowing money, hiring, firing, and rate of pay for employees. They each supervised associate attorneys and signed checks for the PLLC. The respective interests held by Mr. Castigliola, Mr. Banahan, and Mr. Mullen could not have been limited partnership interests under any of the limited partnership acts.

Moreover, a limited partnership must have at least one general partner. See, e.g., Miss. Code Announcement sec. 79-14-801 (2009). This is logical because limited partners, as discussed above, cannot participate in control of the business and maintain their limited liability. Because there must be at least one partner who is in control of the business, there must be at least one general partner. The members testified that all members participated equally in all decisions and had substantially identical relationships with the PLLC. But since by necessity at least one of the members must have occupied a role analogous to that of a general partner in a limited partnership, and because all of the members had the same rights and responsibilities, they must all have had positions analogous to those of general partners in a limited partnership.

The Court rejected IRS's argument that the money in the PLLC's trust fund account at the end of 2010 was taxable income to the PLLC for 2010.

Mr. Banahan testified credibly that the funds in the trust account were not PLLC funds and could not be withdrawn as fees by the members. He was not sure to which clients the funds belonged but was certain that it would be a violation of professional ethics to withdraw the money as fees (the consequences of which might have included disbarment). He was not sure how the discrepancy arose but stated that it may have been attributable to losing the PLLC's office in Hurricane Katrina. He also stated that at some point the money might be deposited into Mississippi's fund for unclaimed moneys. Mr. Banahan's testimony was corroborated by the credible testimony of Mr. Castigliola.

The members testified credibly that the funds IRS identified did not belong to the members. Rule 1.15 of the Mississippi Rules of Professional Conduct requires that a lawyer keep client funds - and funds the ownership of which is disputed - separate from the lawyer's own property. The members argued that, because they knew they did not own these funds, the funds had to be kept separate in the trust account. IRS offered no evidence or arguments to support its contention that the members were entitled to withdraw these funds as fees.

Cates, TC Memo 2017-178

The Tax Court has held that a taxpayer did not prove that she properly rolled over a pension distribution, that the pension distribution was used for qualified higher education expenses, or that the employee business expenses that she incurred were not subject to reimbursement by her employer.

§402(a) provides that "any amount actually distributed to any distributee by any employees' trust described in §401(a) which is exempt from tax under §501(a) shall be taxable to the distributee, in the tax year of the distributee in which distributed, under §72 (relating to annuities)."

§402(c)(1) provides a "rollover" exception to the §402(a) general rule; under §402(c)(1) , any portion of an "eligible rollover distribution" that is paid to an employee and which the employee transfers to an "eligible retirement plan" is excluded from gross income for the tax year in which the distribution is paid. However, this rollover exception is not available for "any transfer of a distribution made after the 60th day following the day on which the distributee received the property distributed." (§402(c)(3) ; Regulation §1.402(c)-2, Q&A 11)

§72(t) imposes a 10% tax on early distributions from a qualified retirement plan. However, the 10% tax does not apply to the extent that early distributions are used for qualified higher education expenses of the taxpayer in the year of the early distributions. (§72(t)(2)(E)) Qualified higher education expenses generally include expenses for tuition, fees, books, supplies, and equipment and, in limited circumstances, room and board. (§72(t)(7)(A) , §529(e)(3))

Under §162 , a taxpayer may deduct unreimbursed employee business expenses as an ordinary and necessary business expense. However, a taxpayer may not deduct any expenses under §162 to the extent that the taxpayer is entitled to (but does not claim) reimbursement from his or her employer for expenditures related to his or her status as an employee. (*Lucas,* (1982) 79 TC 1) In this regard, such expenses are not considered "necessary." (*Podems,* (1955) 24 TC 21)

The taxpayers were Mr. and Mrs. Cates, and the tax year at issue was 2012. All of the issues involved Mrs. Cates.

From 2004 to April 2012, Mrs. Cates was employed at FCCI Insurance Group (FCCI); starting in April 2012 she was employed at Harleysville Insurance Co. (Harleysville). Shortly after joining Harleysville, Mrs. Cates enrolled in a master of business administration (M.B.A.) program at Walden University.

Mrs. Cates was a participant in FCCI's 401(k) profit-sharing plan, which was administered by Vanguard. It was undisputed that Mrs. Cates received a distribution of $133,501 from Vanguard during 2012. As of the close of that year, Mrs. Cates was under 59½ years of age. Vanguard sent IRS and Mrs. Cates a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., for 2012, reflecting the $133,501 distribution as an early distribution with "no known exception."

Walden University sent IRS and Mrs. Cates a Form 1098-T, Tuition Statement, for 2012, reflecting Mrs. Cates's student status as at least a half-time graduate student, zero payments received for qualified tuition and related expenses, and $11,357 billed for qualified tuition and related expenses.

When IRS audited Mr. and Mrs. Cates, it asserted that the full $133,501 was taxable in 2012 and was subject to the early withdrawal penalty. It also objected to certain employee business expenses deducted by the taxpayers.

The Mrs. Cates argued that $25,000 of the $133,501 distribution was nontaxable because that amount should be reflected as a rollover to the Nationwide Savings Plan, which was administered by Charles Schwab for Nationwide Insurance Co. (Nationwide), the company into which Harleysville merged shortly after Mrs. Cates joined Harleysville. The Court rejected this argument.

Mrs. Cates asserted that the $25,000 was "set aside specifically for...a rollover" but acknowledged that the proper paperwork was not actually completed to reflect a rollover of this amount into the Nationwide Savings Plan; according to Mrs. Cates, this failure occurred because of Harleysville's merger into Nationwide. Consequently, as evidence that this rollover occurred, she pointed to documentation from Vanguard showing that as of April 16, 2012, her vested balance in FCCI's 401(k) profit-sharing plan was $140,211.24 and from Nationwide showing that as of September 30, 2014, her vested balance in the Nationwide Savings Plan was $24,531.66.

The Court said that this documentation did not establish that Mrs. Cates rolled over $25,000 (or any other amount) to a Nationwide qualified retirement plan, much less that a rollover was effected within 60 days of her receipt of the $133,501 distribution.

Mrs. Cates argued that a portion of the pension $133,501 distribution qualified for the §72(t)(2)(E) exception because that amount was used to pay expenses related to the M.B.A. program she was enrolled in at Walden University in 2012. The Court rejected this argument.

The Court concluded that there was no evidence in the record that the taxpayers in fact made any tuition and related payments to Walden University in 2012 for Mrs. Cates's M.B.A. studies there. The Form 1098-T that Walden University sent IRS and Mrs. Cates for 2012 showed only amounts "billed" for qualified tuition and related expenses. The form also showed that zero payments were received for qualified tuition and related expenses. Without some documentation to support Mrs. Cates's vague testimony, the Court said that it could not conclude that she used any portion of the $133,501 distribution to pay M.B.A. expenses or that the expenses, even if paid, were qualified higher education expenses within the meaning of §72(t)(7)(A) and §529(e)(3) .

Taxpayer could not take deduction for employee business expenses. Mrs. Cates at trial contended that the taxpayers should be allowed a deduction for various unreimbursed employee business expenses, to wit, tuition and related expenses to Walden University, dues for professional membership organizations, and travel (including vehicle and meals and entertainment) expenses. She further testified that these expenses were not "reimbursable" or "reimbursed."

However, the taxpayers did not produce a copy of Harleysville's reimbursement policy despite Mrs. Cates's acknowledging at trial that Harleysville had such a policy. They did introduce into the record a copy of the employee handbook of FCCI. However, that handbook stated that FCCI reimburses employees for business travel (including lodging, meal, and transportation charges) and registration or tuition fees for educational conferences, conventions, and training seminars (subject to prior supervisory approval of those fees). The handbook also stated that FCCI pays for salaried employees' membership in professional organizations so long as the organization is relevant to the employee's current FCCI job, the employee has been employed with FCCI for 90 days, and the employee obtains supervisory approval of membership in the organization. The handbook further stated that, subject to certain time in service and employee performance conditions, FCCI reimburses an employee up to $5,250 per year for the cost of a college education program (including an M.B.A. program) at a regionally accredited educational institution at the conclusion of a successfully completed course.

The Court said that the taxpayers failed to show why Mrs. Cates's expenses were necessary when it seemed, contrary to what she may have believed, that she could have sought reimbursement for them. Although her testimony also implied that she may have sought reimbursement for some of the expenses but was denied, the taxpayers did not produce any supporting documentation to that effect.

Coates, TC Memo 2016-197.

The Tax Court has upheld taxpayers' casualty loss deductions for one of two tornado-damaged properties they owned. The Court found the taxpayers' estimates of one property's pre- and post-tornado values to be credible and upheld the deduction for the decline in value. However, for the second property, although the Court found that the taxpayers established the parcel's decline in value, it denied the deduction because the taxpayers failed to establish that they had any basis in the property.

§165(a) generally allows a deduction for any loss sustained during the tax year and not compensated for by insurance or otherwise. For individual taxpayers, §165(c) limits these deductions to three categories of losses: (1) losses incurred in a trade or business, (2) losses incurred in any transaction entered into for profit but not connected with a trade or business, and (3) losses of property (a) not connected with a trade or business or a transaction entered into for profit and (b) arising from fire, storm, shipwreck, or other casualty, or from theft. Losses under §165(c)(3) (e.g., fire, casualty, etc.) are allowed as a deduction only to the extent that the amount of the loss exceeds $100, and then only to the extent that the aggregate amount of such losses exceeds 10% of the taxpayer's adjusted gross income (AGI). (§165(h))

The amount of a casualty loss is the difference between the fair market value (FMV) of the property before the casualty and the FMV of the property after the casualty. (Regulation §1.165-7(a)(2)(i)) Both values must generally be determined by "competent appraisal," but the difference in values can also be "evidenced" by repairs to the property. (Regulation §1.165-7(a)(2)(ii)) For this purpose, the cost of repairing the property must be the actual cost incurred to repair the property, not an estimate, unless the best use of the property after the casualty would require its repair, in which case the decline in value can be inferred from an estimate of that cost. (*Abrams,* TC Memo 1981-231)

A casualty loss cannot exceed the adjusted basis of the property for determining the loss from the sale or other disposition of the property. (§165(a)) The amount of the loss is also reduced by the amount of compensation received on account of the loss. (§165(a))

Howard and Tandi Coates owned a large amount of land in Oklahoma, including an 80-acre parcel on which their house and two barns were located, and an adjacent 440-acre parcel of undeveloped woodland used for hunting that contained thousands of mature oak trees and was populated by wild turkeys, deer, and wild boar.

On January 11, 2010, the Coateses commissioned an appraisal of 120 acres they owned that included the 80-acre parcel. The appraisal concluded that the 120 acres' FMV was $677,000.

On May 10, 2010, a tornado cut through the ranch, significantly damaging the property and flattening the woodlands. On the 80-acre parcel, the tornado damaged the house and barns, tore down fences, and knocked down trees. On the 440-acre parcel, it demolished 80%-90% of the oak trees, and without the tree cover, this property became covered in dense, impassable scrub and no longer provided a suitable habitat for the wild turkeys, deer, and wild boars.

The Coateses had property insurance on the 80-acre parcel, which covered damage to the house and barns but not to the land or fences. After the tornado, the Coateses' insurance company examined the house and barns and estimated the costs of repairing them at roughly $24,000-$28,000. Because the Coateses believed that their insurance company had underestimated the costs, they hired a loss-recovery advocacy service (Advocacy), at a cost of around $20,000, to provide an estimate of the cost to repair the house and barns. On its May 23, 2010 estimate, Advocacy projected that it would cost $189,000 to repair the house and barns, and the Coateses used this estimate to negotiate with the insurance company. In the end, the insurance company compensated them $168,000, which the Coateses used for the repairs. The Coateses reported on their tax return that the insurance reimbursement was $148,000-i.e., the $168,000 compensation less the $20,000 cost of obtaining the estimate. The Coateses also incurred other costs to repair the tornado damage to the 80-acre parcel, such as the cost of repairing fences.

The Coateses did not insure the 440-acre parcel and did not receive any payments for damage to it. Mr. Coates partially cleared that property of debris, seeded it with grass, and repaired some fences. He is still in the process of converting it to grazing use. The amount thus far spent on converting the property was not in evidence.

On their timely filed 2010 return, the Coateses reported a total casualty loss of $127,900 for damage to the two parcels as a result of the tornado. The computations were reported on the form as follows:

a. With respect to the 80-acre parcel: $500,000 reported adjusted basis, $660,000 FMV before casualty, $450,000 FMV after casualty for a decline of $210,000, less insurance reimbursement of $148,000 yields loss, before statutory limits, of $62,000.

b. With respect to the 440-acre parcel: $247,000 adjusted basis, $528,000 FMV before casualty, $440,000 FMV after casualty for a decline of $88,000, with no insurance reimbursement yields loss, before statutory limits, of $88,000.

c. Total loss before statutory limits: $150,000, less statutory limits of $100, and 10% of AGI ($22,000) yields a casualty loss of $127,900.

IRS issued a deficiency notice to the Coateses, disallowing the $127,900 casualty-loss deduction and determining a $32,000 deficiency. IRS also imposed an accuracy-related penalty.

The Court first upheld the Coateses' deduction with respect to the 80-acre parcel, using the before/after approach and accepting Mr. Coates' calculation of the pre- and post-tornado values of the property. The Court reasoned that he was credible and knowledgeable because he owned the property before and after the tornado, had substantial experience working with timberland and farmland, had bought and sold various properties in the area, and had previously purchased damaged or overgrown land and restored it to workable condition. The fact that the $660,000 "before" value was arguably inconsistent with the 2010 appraisal (of the 80-acre parcel plus another 40 acres for $677,000) did not, in the Court's view, make Mr. Coates' valuation unreasonable, nor did the fact that the insurance company only paid $168,000 (which was limited to damage to the house and barns, but not land, trees, and fences).

The Court also found that IRS waived any challenge to the Coateses' basis in the 80-acre parcel by not raising the issue in its brief. The Court then found that their adjusted basis was at least $210,000, which was sufficient for purposes of the loss limitations under §165. The Court also found that IRS was bound by its stipulation that the Coateses received $148,000 for damage to the parcel (i.e., $168,000 as reduced by the $20,000 payment to Advocacy) and could not contest the $20,000 reduction.

With respect to the 440-acre parcel, the Court similarly found Mr. Coates' $528,000 pre-tornado and $440,000 post-tornado valuations to be credible. The Court also accepted Mr. Coate's view that the best use of the property after the tornado was to convert it to grazing land, and credited Mr. Coates' estimated $88,000 cost of converting the damaged land to grazing land.

However, the Court agreed with IRS that the Coateses failed to establish their adjusted basis in the 440-acre parcel. The record was unclear as to how they acquired the property, and while Mr. Coates testified that he bought it from his mother, he did not say how much he paid or when the transaction took place, and notations in the relevant deeds indicated that the property was transferred by gift. The Coateses also failed to prove any positive adjustments to their basis. Accordingly, the casualty loss deduction was denied with respect to the 440-acre parcel.

Accordingly, allowing only the casualty loss deduction for the 80-acre property, taking into account the statutory limits, the Court found that the Coateses were entitled to a $39,900 casualty loss deduction. The Court also determined that the Coateses were not liable for an accuracy-related penalty, finding that Mr. Coates arrived at the valuations he reported using his expertise and did not act negligently.

Cooke, TC Memo 2017-74.

A bed and breakfast owner who stayed at the facility himself for many days during the years at issue was subject to the §280A rule that disallows deductions with respect to properties that are used as a personal residence. The Court found that the taxpayer failed to establish the amount of time that he engaged in repairs and maintenance of the property and thus could not rely on the exception in §280A(d)(2).

§162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business. §212(1) and §212(2) allow a deduction for ordinary and necessary expenses paid or incurred in connection with an activity engaged in for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

Under §280A(a), no deduction is generally allowed with respect to any dwelling unit that the taxpayer uses as a residence during the tax year. Any deductions to which a taxpayer would otherwise be entitled under either §162 or §212 will be disallowed if he uses the property as a residence within the meaning of §280A(d)(1). A dwelling unit is used as a residence if the taxpayer uses it for personal purposes for more than the greater of 14 days or 10% of the number of days during the tax year that the unit is rented at a fair rental value. (§280A(d)(1)) A passthrough entity is considered to have made personal use of a dwelling unit on any day on which any beneficial owner would be considered to have made personal use of the unit. (*Holmes,* (CA 2 1996) 78 AFTR 2d 96-5077)

If a taxpayer uses a dwelling unit for personal purposes for any part of a day, generally that day is counted as one of personal use for determining whether the taxpayer used the unit as a residence during the tax year. (§280A(d)(2)) If the taxpayer is engaged in repairs and maintenance of the dwelling unit substantially full time on any day, such use will not constitute personal use of the unit. (§280A(d)(2) (flush language); *Twohey,* TC Memo 1993-547)

Under Proposed Regulation §1.280A-1(e)(6), "a dwelling unit shall not be deemed to have been used by the taxpayer for personal purposes on any day on which the principal purpose of the use of the unit is to perform repair or maintenance work on the unit." The proposed regulation sets forth a "facts and circumstances" test to determine the taxpayer's principal purpose for the use of the unit. The facts and circumstances include, but are not limited to, the amount of time devoted to repair and maintenance work, the frequency of use for repair and maintenance work, and the presence and activity of companions.

A day spent traveling to or from the property, on which the taxpayer is at the property but performs no repairs and maintenance, should not be counted as a day of personal use if the principal purpose of the trip as a whole is to perform repairs and maintenance. (Proposed Regulation §1.280A-1(e)(7), Ex. 3)

The taxpayer, Mr. Cooke, a resident of Anchorage, Alaska, owned a 50% interest in French Lick, a limited liability company taxed as a partnership.

French Lick owned a property in Indiana, which it attempted to operate as a bed and breakfast. However, the bed and breakfast was not financially successful. In September 2009, French Lick listed the property for sale. In January 2010, French Lick discontinued the bed and breakfast operation; there was no rental activity of any type after that date.

During the years at issue, 2010 and 2011, caretakers resided at and took care of the property.

During 2010 and 2011, Cooke made several trips to the Indiana property while the property was listed for sale. Cooke kept records of the airline tickets and car rentals that he purchased for his travel to and from the Indiana property. He kept receipts of purchases that he made during his trips to the Indiana property, including receipts for meals, gas, and hardware and grocery store purchases. He did not keep contemporaneous logbooks of his activities at the Indiana property.

Cooke made three trips to the Indiana area in 2010 and four more in 2011. The total number of days or partial days of those trips, including travel days, was 26 in 2010 and 33 in 2011. For each trip, he stayed all but a day or two at the Indiana property. For each trip, he also spent time in the Louisville, Kentucky area at the Horseshoe Resort and Casino. On one of the trips, he also spent two nights and three days at his college reunion in Cincinnati, Ohio.

On its 2010 and 2011 federal income tax returns, French Lick took deductions for all of the expenses related to the Indiana property. IRS disallowed all expenses that §280A caused to not be deductible.

The Court held that Cooke used the Indiana property for personal purposes for more than 14 days during each of 2010 and 2011. The deductions that Cooke claimed for losses allocated to him from French Lick for the tax years in issue were thus disallowed pursuant to §280A.

The record established that Cooke was at the Indiana property for at least a part of each of 26 days in 2010 and 33 days in 2011. Cooke testified that he spent numerous hours on "business activities" during each of his trips to the Indiana property. He relied on daily activity logs (logbooks) that he created during examination.

Cooke testified that he engaged substantially full time in maintenance and repair activities during every day he spent at the property in 2010 and all except for possibly two days in 2011. Cooke contended that the days that he spent traveling from and back to Anchorage should not be counted as personal use days of the Indiana property because the principal purpose of each trip during the tax years in issue was to perform repairs and maintenance. Cooke also argued that any days that he spent visiting the Louisville area should not count as personal use days because on these days he traveled to spend "time away from the owned premises" and the principal purpose of his time spent at the Indiana property was otherwise to perform repairs and maintenance.

His testimony did not provide specific details about the activities that he performed. No other witnesses testified to verify that Cooke conducted repairs and maintenance during his trips to the Indiana property.

From Cooke's testimony and the logbooks, there was no evidence of disrepair of the Indiana property and no specific details of what was to done to improve it. After January 2010 French Lick did not rent out the Indiana property during the tax years in issue. Aside from Cooke's own visits, there was no specific use for which to repair and maintain the property. Cooke's records indicated that the caretakers had duties and responsibilities with respect to maintaining the property. And, French Lick employed a landscaping firm during the tax years in issue. Cooke's records showed that landscaping services were performed at the Indiana property every month from May through December 2010, as well as March and May through December 2011.

Cooke testified that he reconstructed the business activity summaries in the logbooks by reviewing the records and receipts that he maintained for each of his trips to the Indiana property and the QuickBooks records for French Lick, which also reflected purchases made during those trips. The Court found that Cooke's records generally did not substantiate that he performed the activities reported in the logbooks.

For many of the days that Cooke was at the Indiana property, his business activity summaries included activities such as traveling to visit with past vendors and business contacts, meetings with the resident caretaker and other service providers for the property, and discussions with the local real estate agent. These activities may constitute business activity under other Code sections, but they are not the repairs and maintenance contemplated by §280A(d)(2). The logbooks did not provide sufficient information for the Court to determine how much time Cooke spent on repairs and maintenance. Even when Cooke's records appeared to corroborate a specific repair or maintenance activity on a specific day reported in the logbooks, the Court could not determine whether Cooke's time spent on such repairs and maintenance on that day amounted to engagement on a substantially full time basis.

The Court concluded that Cooke failed to establish that he engaged in repairs and maintenance substantially full time on any of the days that he was present at the Indiana property. And, he failed likewise to establish that the primary purpose of any of his trips was to perform repairs and maintenance on the property.

Creigh, TC Summary Opinion 2017-26.

A software engineer could not deduct the costs of obtaining an executive master of business administration (EMBA) because the degree qualified her for a new profession, rather than refined her existing business skills.

Education expenses are deductible under §162(a) if made by a taxpayer either to maintain or improve skills required in his business or employment or to meet the express requirements of his employer, or the requirements of law or regulations, imposed as a condition to retaining his salary, status or employment. (Regulation §1.162-5)

However, deductions are not allowed if the education:

a. Is needed to meet the minimum requirements for taxpayer's present or intended employment, trade, business or profession (Regulation §1.162-5(b)(2)) or

b. Is undertaken to fulfill general education aspirations or for other personal reasons, or

c. Is part of a program of study that will lead to qualifying the individual in a new trade or business. (Regulation §1.162-5(b)(3)(i))

In *Allemeier,* TC Memo 2015-207, the Tax Court held that a taxpayer who pursued an MBA did not significantly change his tasks and duties when his prior work involved designing marketing strategies for products, conducting informational seminars, or other management, marketing, and finance-related tasks directly related to the MBA coursework. The MBA program merely improved these preexisting skills that the taxpayer used before enrolling in the program and did not qualify the taxpayer for a new trade or business.

In *Blair,* TC Memo 1980-488, the Tax Court held the taxpayer's MBA program did not qualify her for a new trade or business because there was substantial overlap in the tasks she performed before and after the MBA program. In her role as a personnel representative before the education, the taxpayer made hiring recommendations, suggested personnel policy improvements, estimated the fair salary level for various jobs within the company, and assisted employees with problems involving health and other employee benefits. Although the taxpayer was promoted to personnel manager after starting the MBA program, her duties were consistent with her role as a personnel representative; and her new ability to make hiring decisions, as opposed to recommendations, and the change in her title were not enough for the Court to find her qualified for a new trade or business.

From 1993 to 1997, Megan Zhao Creigh worked as the head of information technology where she developed and managed a computerized information system, created an information technology strategy, and managed corporate information technology operations.

From 1997 to 2007, she worked as a project manager for the consulting unit of another company where she used her skills as a software engineer to manage teams of consultants and professionals in designing and implementing the integration of business processes and computer software systems.

Returning to work in 2010 after devoting time to raising her son, she launched her own independent consulting business doing the same type of consulting work that she had previously done for the consulting unit.

Mrs. Creigh learned that management professionals working for the companies she sought as customers were attending EMBA programs. She believed that, through an EMBA program, she could network, build relationships with these management professionals, and eventually be introduced to her customers who needed a consultant to design, develop, test, and implement computer software systems that improved business processes. In September of 2011, she matriculated at the University of California, Los Angeles (UCLA) EMBA program, from which she graduated in June 2013.

In 2012, the year at issue in this case, she ran her independent consulting business as a sole proprietorship, but did not have any consulting clients and did not report any gross receipts from consulting. On her 2012 return, she claimed a $64,704 loss from her business, consisting of: $59,282 for tuition, fees, and expenses associated with the EMBA program; $4,973 for car and truck expenses for her travel from her home to UCLA to attend the EMBA classes and events; and $449 for supplies.

On audit, IRS challenged the deductions, and Mrs. Creigh sought relief in the Tax Court.

The Tax Court found that Mrs. Creigh's 2012 education expenses for tuition, fees, and associated expenses were not deductible because the EMBA program qualified her for a new trade or business.

In contrast to Allemeier and Blair, Mrs. Creigh's tasks and duties in her prior employment, before enrolling in the EMBA program, were largely unrelated to her EMBA coursework. While she may continue to be qualified to manage people as a project manager, she also became qualified to perform a myriad of business, management, finance, and marketing tasks she had not been qualified to perform before enrolling in the EMBA program.

The Court reasoned that the EMBA program qualified her to perform tasks that were significantly different from those she had performed in her prior employment. Mrs. Creigh testified that in her prior employment her tasks and skills centered on analyzing and designing computer software systems to improve or replace business processes to make them more efficient. Her projects also involved designing, developing, testing, and implementing computer software systems. Her education was in software engineering, which enabled her to understand how computer software systems worked and how to use or modify them to improve business processes.

She testified that in her prior employment she was not involved in business strategy development or marketing. Her management skills were limited to managing people on a particular project. She also testified that the courses she took in the EMBA program "did not really help in my area, in terms of project management." The EMBA program courses that she completed were varied and encompassed a large number of business fields: economics, management, finance, accounting, marketing, mergers and acquisitions, business policy, negotiations, valuation, and international business. Mrs. Creigh's skills in her prior employment, except for perhaps managing people on her projects, did not include skills related to any of the studied business fields.

The Tax Court found that although her prior work as an employee involved some management skills-e.g., managing people who worked on her projects-she testified that she did not engage in other business management tasks, such as strategy development or marketing, because she did not have the skill set to do so. Mrs. Creigh testified that she hoped to expand her consulting work into these other fields.

The new skills Mrs. Creigh learned were exemplified by a project for a laboratory that she worked on as part of her EMBA program, consulting on the feasibility of establishing an internal consulting division: the project required her to determine how the quality systems division could provide individualized and quality control consulting services to its customers worldwide. These tasks were unrelated to her prior work in designing and developing computer software systems and integrating and implementing them to improve business processes.

Derolf, et al v. Risinger Bros. Transfer, Inc., et al, (DC IL 4/21/2017) 119 AFTR 2d ¶2017-692.

A district court has denied two truck drivers' claims alleging, among other things, that they were misclassified as independent contractors and that the company they worked for violated §7434 by issuing them 1099 tax information returns instead of W-2s. While the court found that the drivers were independent contractors so the company's issuance of 1099s was proper, the court also found that even if they had been misclassified, such would not have given rise to a cause of action under §7434 because that provision is limited to cases involving a fraudulent misstatement as to the amount paid.

The classification of a worker as an independent contractor or employee affects taxes in a number of ways, including withholding. Employers must withhold income tax from wages paid to employees, but not from amounts paid to independent contractors.

In general, information returns are required to be filed for compensation paid by persons engaged in a trade or business, to individuals, whether as employees or nonemployees, in the course of the person's trade or business. Employees receive Form W-2, Wage and Tax Statement, and nonemployees receive Form 1099-MISC, Miscellaneous Income.

Under §7434(a), if any person willfully files a fraudulent information return with respect to payments purported to be made to any other person, the purported payee may bring a civil action for damages against the person filing the fraudulent return.

Debbie Derolf and Kevin Anderson were truck drivers who hauled freight for Risinger Bros. Transfer, Inc. (Risinger). Among other claims, Derolf and Anderson allege that Risinger violated the §7434 by purposefully misclassifying them and others similarly situated to them as independent contractors and willfully filing fraudulent information returns-i.e., by issuing them 1099 tax information returns instead of W-2 tax information returns. Risinger moved to dismiss under Federal Rules of Civil Procedure 12(b)(6) for failure to state a claim.

The court determined that Derolf, Anderson, and those similarly situated to them were independent contractors, so no misclassification occurred and Risinger correctly filed Form 1099 information returns.

In addition, the court found that, regardless of whether they were misclassified, Derolf's and Anderson's claims were not cognizable as pled. The court noted that §7434 clearly provides a private right of action to aggrieved persons with respect to whom a fraudulent false return was filed, but found that there was an unresolved split amongst the district courts as to the type of fraud that gives right to a cause of action under §7434. Some courts have ruled that the nature of the fraud must pertain solely to the pecuniary value of the payments at issue, while others have interpreted it more broadly.

Ultimately, the court agreed with the interpretation set out in *Liverett v. Torres Advanced Enter. Sols. LLC,* (DC VA 2016) 192 F. Supp. 3d 648, which, after analyzing the text of the statute and Congressional intent, concluded that there is a private cause of action under §7434(a) "only where an information return is fraudulent with respect to the amount purportedly paid to the plaintiff." The Liverett court then concluded that "a Form 1099 that identifies plaintiff as an independent contractor when he is an employee is an information return that is false with respect to plaintiff's employment status, but so long as the Form 1099 accurately reports the amount of wages defendant paid to plaintiff, the return is not fraudulent with respect to the amount of the payments made."

The court found this holding, which applies equally to the facts of this case, to be supported by the clear language of the statute. Namely, §7434(a) prohibits willfully filing "a fraudulent information return with respect to payments purported to be made to any other person," and §6724(d)(1)(A), in turn, defines an information return as "any statement of the amount of payments to any other person required by" certain Code provisions (emphasis added). Therefore, the court concluded that a §7434 violation must be predicated on a purported misstatement of amount.

This interpretation was further supported by §7434(e), which requires a court awarding damages in a §7434(a) action to "include a finding of the correct amount which should have been reported in the information return." The court reasoned that "[i]f the relief contemplated under the statute is limited to the amount of money that should have been documented on the information return, then as a matter of logic the right of action is similarly limited to alleged false statements of the amounts earned and documented on the information return."

Drah, TC Memo 2017-149.

An independent contractor for FedEx, who also received wages from his wholly owned C Corporation that contracted to provide services for FedEx, was not entitled to business deductions for contract labor expenses, depreciation and section 179 expense, and repair and maintenance expenses. The taxpayer generally failed to substantiate the amount and/or business purpose of many of the expenses; and certain other expenses, including those related to a vehicle leased by the C Corporation, were properly deductible by the C Corporation and not the taxpayer himself.

Under §162(a), a taxpayer may deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." The burden is on the taxpayer to prove his or her entitlement to deductions allowed by the Code and to substantiate the amounts of expenses underlying claimed deductions. (§6001; *Indopco Inv. v. Commissioner,* (S Ct 1992) 69 AFTR 2d 92-694) A taxpayer's failure to keep and present accurate records counts heavily against a taxpayer's attempted proof. (*Rogers,* TC Memo 2014-141)

§167(a) allows a depreciation deduction for the exhaustion, wear and tear, or obsolescence of property used in a trade or business, and §179(a) and §179(b) allow a taxpayer to elect to deduct as a current expense, within certain dollar limitations, the cost of "section 179 property" in the year such property is placed in service. In order to qualify as section 179 property, the property must, among other things, be "acquired by purchase for use in the active conduct of a trade or business." (§179(d)(1)(C))

In 2011, Stephen Drah worked as an independent contractor for FedEx, a national parcel delivery company. He also received wages from S Drah Courier, Inc. (SDC), his wholly owned C Corporation, which contracted to provide courier services for FedEx. During 2011 SDC filed corporate income tax returns reporting its income and expenses, which included the wages it paid Drah.

Drah got an extension to file his 2011 individual return but failed to file by the extended due date, so IRS, on the basis on third-party information reports, prepared a substitute return under §6020(b) and sent Drah a notice of deficiency. The deficiency notice determined that, for 2011, Drah had total income of $61,773, consisting of $29,895 in non-employee compensation from FedEx and $31,878 in wages from SDC. IRS accorded Drah the filing status of married filing separately and allowed him the standard deduction and one personal exemption, which overall resulted in a deficiency of $12,341 and additions to tax for failure to timely file and pay.

Drah conceded that he received the income, but asserted that, as an independent contractor for FedEx, he was entitled to claim business expense deductions on Schedule C, Profit or Loss from Business, for contract labor expenses of $10,184, depreciation and section 179 expense of $20,000, and repair and maintenance expenses of $5,446. He also conceded his liability for the additions to tax to the extent that the Tax Court sustained the deficiency.

The Tax Court found that Drah was not entitled to the claimed business expense deductions.

With respect to the contract labor expenses, the Court noted that at trial Drah did not explain the nature of his alleged contract labor expenses, nor did he provide any documents or testimony to show that he actually incurred those expenses, establish their amount, or prove that any costs he incurred were ordinary and necessary expenses of his business as an independent contractor for FedEx. Thus, the Court found that he failed to carry his burden of proving entitlement to any deduction. (*Galbraith,* TC Memo 2016-168)

The Court then upheld IRS's denial of Drah's depreciation and section 179 expense deduction, which was claimed for a commercial delivery vehicle that Drah himself did not actually own. Rather, it was leased-by SDC, not Drah-and the lease agreement specifically stated that the lessee is not treated as the owner for tax purposes. Rather, any deduction for depreciation or section 179 expense would be claimed by the lessor as owner. (Weiss v. Wiener, (S Ct 1929) 7 AFTR 8865) The Court also noted that the lease expense was presumably deducted on SDC's corporate income tax return for 2011.

Finally, the Court denied Drah's claimed repair and maintenance expense deductions. The invoices that Drah submitted at trial from various auto repair shops failed to establish that any payment was actually made, and some of them appeared to be estimates rather than bills. The invoices also did not uniformly establish the vehicle on which the work was performed, so Drah further failed to establish that the work was done on vehicles that he used for business rather than personal purposes. And, the Court noted that, to the extent the work was performed on delivery vehicles used for business purposes, Drah did not establish that they were used in his Schedule C business as an independent contractor for FedEx. Finally, while some of the invoices showed Drah as the customer, others showed SDC; and, similar to the lease expense, the Court noted that those expenses presumably would have been deducted by SDC on its corporate return.

Dulik, TC Summary Opinion 2017-51.

The Tax Court has ruled that a CPA's legal expenses were paid in connection with negotiating the terms of his severance agreement with a former employer rather than in connection with his activity as the sole shareholder of an S corporation formed after his dismissal, and thus were not deductible as ordinary and necessary business expenses but could be claimed only as miscellaneous itemized deductions. But the Tax Court declined to hit him with an accuracy-related penalty.

In general, expenses not incurred in carrying on a trade or business activity but in the production or collection of income are deductible only as miscellaneous itemized deductions on Schedule A. Miscellaneous itemized deductions are deductible only to the extent that the total of such deductions exceeds 2% of the individual's adjusted gross income. Itemized deductions may be limited under the overall limitations on itemized deductions under §68 and may have an alternative minimum tax implication under §56(b)(1)(A)(i).

The deductibility of legal fees as trade or business expenses under §162 depends on the origin and character of the claim for which the legal fees were incurred and whether that claim bears a sufficient nexus to the taxpayer's business or income-producing activities. In *Gilmore,* (S Ct 1963)

11 AFTR 2d 758, the Supreme Court said that "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test."

In *Test*, TC Memo 2000-362, aff'd (CA 9 2002) 90 AFTR 2d 2002-6596, the taxpayer pursued legal claims related to her employment with the University of California (University) as director of the Center of Prehospital Research and Training in part because she feared harm to her reputation which, in turn, would harm a business, Save-a-Life Systems (SLS), that she operated independent of her position at the University. While she was launching SLS, the taxpayer's University department became the subject of a State audit. The taxpayer retained counsel to respond to negative publicity and attempt to prevent the public release of the draft of the audit report, among other things. The taxpayer claimed that she did so primarily to maintain her professional reputation which was important to the success of SLS. The Tax Court held that it had to look to the origin of the claim and that the taxpayer's motives were not relevant. Because the claim originated in her employment at the University, not with her operation of SLS, the legal fees could not be claimed as business deductions on Schedule C (Profit or Loss From Business), but rather were properly claimed as miscellaneous itemized deductions.

When he was employed as "vice-president finance" at Byk-Gulden, a small domestic pharmaceutical company, Arthur Dulik, a CPA, signed a secrecy agreement that included a 2-year noncompete covenant. Subsequently, Byk-Gulden became part of Nycomed US, Inc., which was Dulik's employer from 2006 until May 2010. He served in senior executive posts and was a participant in the company's supplemental executive retirement program (SERP).

In 2010, Nycomed terminated Dulik's employment and offered him a severance agreement. The agreement was for one year's worth of pay, a prorated bonus for 2010, and one year's worth of continuing COBRA coverage. Additionally, the agreement incorporated by reference the secrecy agreement Dulik had signed with Byk-Gulden. In exchange, Dulik would agree to: (1) comply with the secrecy agreement, (2) release all claims against Nycomed arising out of his employment with the company, and (3) not make disparaging remarks about the company.

Dulik did not want to sign the severance agreement as proffered and hired two law firms to help him negotiate the terms of his agreement. Presumably on advice of counsel, Dulik told Nycomed he wanted to modify the terms of the severance agreement by: (1) removing the secrecy agreement; (2) adding a provision that he be able to disclose to prospective employers that he was covered by a restrictive covenant; and (3) adding a provision that the nondisparagement clause be mutual. He also disagreed with Nycomed's position regarding the post-employment benefits that he would receive under the SERP.

Nycomed stuck to its guns and said, among other things, that it would withdraw the severance agreement if Dulik did not promptly sign it. After talking to his lawyers, Dulik threw in the towel and signed the agreement as originally offered. During 2010, Dulik paid his lawyers a total of $26,325 for legal services that included reviewing his SERP entitlement, severance negotiations, and correspondence with Nycomed.

In September of 2010, one month after he signed the severance agreement, Dulik incorporated AED Associates II, Inc. (AED) and caused it to elect treatment as an S corporation. He was the president and sole shareholder and timely prepared and filed for AED a 2010 Form 1120S, U.S. Income Tax Return for an S Corporation. AED did not report any gross receipts or sales and claimed a total of $31,125 in deductions for expenses, including a deduction of $26,781 for "legal and professional" expenses, resulting in a loss of $31,125.

Dulik and his wife (also a CPA) timely filed a joint 2010 Form 1040, U.S. Individual Income Tax Return, reporting the $31,125 loss from AED on their Schedule E, Supplemental Income and Loss.

IRS disallowed the $26,781 deduction for legal fees claimed as ordinary and necessary business expenses relating to AED, determining that the attorney's fees related to Mr. Dulik's employment and should properly have been deducted on their Schedule A, Itemized Deductions.

Dulik did not assert that his claim against Nycomed was rooted in his consulting business; instead, he contended that the origin of the claim was Nycomed's restriction on his ability to work. Dulik said he hired counsel solely to renegotiate the terms of the severance agreement so that he could operate a business as a consultant in the pharmaceutical industry. He asserted that, but for his desire to work in the pharmaceutical industry, he would have not hired counsel; for example, if he had wanted to work as a CPA for an accounting firm, he would not have tried to negotiate the terms of the severance agreement. Dulik also claimed that he did not incorporate AED until September 2010 because he originally thought he was going to do business as a Schedule C proprietorship but later formed a subchapter S corporation because he was afraid legal issues could arise out of some of his activities.

Citing *Gilmore* and *Test*, the Tax Court said that, although the terms of the severance agreement may have prevented Dulik from operating a consulting business in the pharmaceutical industry, the key was the origin of the claim, not the potential consequences of a win or loss in negotiating the terms of the severance agreement.

Dulik's claim arose from his status as a former employee of Nycomed, not from his consulting business, the Tax Court said. He hired attorneys because he was trying to negotiate the terms of the severance agreement offered in connection with the termination of his employment at Nycomed. Thus, the Tax Court concluded that Dulik could not deduct the legal fees as ordinary and necessary business expenses of his consulting business as a flowthrough from AED. In a footnote, the Court also pointed out that Dulik was not "carrying on" a trade or business when the legal expenses were made, as required by §162. Expenses paid after a decision has been made to start a business, but before the business commences, are not deductible as ordinary and necessary business expenses.

The Tax Court did hold, however, that Dulik was entitled to claim $26,3256 as a miscellaneous itemized deduction on Schedule A, subject to the limitations on such deductions.

IRS said the accuracy-related penalty under §6662 was appropriate because Dulik and his wife were both CPAs, but the Tax Court declined to apply the penalty to the extent it was attributable to the legal fees.

The accuracy-related penalty does not apply to any portion of the underpayment for which the taxpayer shows that there was reasonable cause and that he or she acted in good faith. (§6664(c)(1))

Dulik kept adequate records to substantiate his legal fees. Additionally, the underpayment in Dulik's case was primarily attributable to the characterization of the claimed deduction for legal fees, rather than disallowance of the deduction. The Tax Court opined that the origin of the claim doctrine is a technical area of law, is fact intensive, and requires a reference to and analysis of caselaw. Under the circumstances, the Tax Court concluded that Dulik had reasonable cause and good faith in his treatment of the deduction for legal fees.

Edwards, TC Summary Opinion 2017-52.

A purported joint return filed by a taxpayer for himself and his soon-to-be ex-wife was invalid because it was filed without her consent, and that the taxpayer's proper filing status was married-filing-separate. Although the taxpayer and his wife had discussed filing a joint return and had done so in the past, there was no actual agreement to file jointly, and the wife's actions indicated that she did not know that a joint return had been filed on her behalf. The Court declined to impose accuracy-related penalties, finding that the taxpayer acted reasonably and in good faith at the time the return was filed.

Under §6013(a), two spouses are permitted to file a joint return. Spouses who elect to file a joint return for a tax year are required to compute their tax on the aggregate income of both spouses, and both spouses are jointly and severally liable for all tax due. (§6013(d)(3); *Harrigton,* TC Memo 2012-285)

Married filing jointly status does not apply to a return unless both spouses intend to make a joint return. (*Jones v. Commissioner,* (CA 4 1964) 13 AFTR 2d 1821) Although both spouses are required to sign the joint return, the failure of one spouse to sign does not necessarily negate the intent to file a joint return by the non-signing spouse. (*Estate of Campbell,* (1971) 56 TC 1)

Whether an income tax return is a joint return or a separate return of the other spouse is a question of fact. (*Harrington*) In determining whether a non-signing spouse intended to file a joint return, courts have considered factors including (1) whether the returns were prepared pursuant to an established practice of preparing and filing a joint return, (2) whether the non-signing spouse failed to object to the filing of a joint return, (3) whether an affirmative act was taken indicating an intention to file other than jointly, (4) whether one spouse entirely relied on the other spouse to file returns, (5) whether the spouse examined returns presented for a signature, (6) whether separate returns were filed, (7) whether the returns included the income and deductions of the non-signing spouse, and (8) and whether the non-signing spouse was aware of the contents of the purported returns. (*Estate of Campbell*)

Victor and Sharon Edwards married in 1986. On June 21, 2013, Victor filed for divorce; the divorce was finalized in 2014. With the exception of a 2-week period, they shared a home in 2013.

On February 8, 2014, Sharon sent Victor a text message proposing to file a joint return for 2013 and split the refund, which they agreed to discuss later. On February 12, 2014, Victor filed a 2013 joint return for them both which was prepared by his longtime tax return preparer.

In prior years, Victor, with Sharon's actual or implied consent, would provide all of the couple's tax information (including Sharon's Form W-2s that were mailed to their shared residence) to the preparer, who would then use it to prepare a return. Sharon had not thoroughly reviewed the couple's prior tax returns before they were submitted and had never met the preparer, but she would sign an authorization for the return to be submitted on her behalf, which Victor would return to the preparer before the return was submitted. Sharon was not provided with a copy of the 2013 joint return, and she did not sign the return or any other authorization before Victor filed it.

On the purported 2013 joint return, Victor reported wage income of $30,714, $26,777 of which was attributable to Sharon. IRS processed the return and issued a refund check, in March 2014, for $6,240, which Victor cashed. During the pendency of their divorce, Victor and Sharon were jointly responsible for certain household expenses, but Victor felt that she owed him money because she had not paid her share. Victor did not immediately inform Sharon that he had filed the 2013 return or that he had received a refund, and he did not share any of the refund with her.

On April 5, 2014, Sharon sent Victor an additional text message inquiring about whether they should file a joint return for 2013, to which he responded that she should "talk to the Judge about it." She subsequently sought a filing extension. Throughout the summer of 2014, attorneys for Victor and Sharon exchanged emails concerning the divorce proceedings. Through the summer, Sharon apparently believed that Victor had filed a married filing separately return on his own behalf for 2013 on which he had claimed both of the couple's children as his dependents.

A divorce decree was entered on September 5, 2014, but it did not mention Victor and Sharon's tax status for 2013.

On October 6, 2014, Sharon tried to file a married filing separately return for 2013, which IRS rejected. She then asked Victor if he filed a return using her Social Security number, to which he responded that she "do[es]n't need to file." IRS received a return from Sharon on October 18, 2014, reflecting a married filing separate status and claiming both children as dependents. IRS informed her that its records showed that she had now submitted two income tax returns for 2013 and requested an explanation. Her reply indicated that she did not file more than one return for 2013, that her filing status was married filing separately, and that Victor had used her Social Security number without her knowledge. Sharon provided IRS with a Form 14039, Identity Theft Affidavit.

IRS then determined that Victor's correct filing status for 2013 was married filing separately and accordingly removed from his return wages, Federal income tax withholding, and a personal exemption attributable to Sharon, as well as claimed dependency exemptions for the two children, an earned income tax credit, and claimed charitable contributions. IRS also imposed an accuracy-related penalty against Victor. Victor filed a Tax Court petition asserting that he filed a valid joint tax return for 2013 and challenging the penalty.

The Tax Court concluded that Victor did not show that he and Sharon agreed to file a joint return for 2013. The Court noted that, unlike in prior years, Sharon did not sign a filing authorization for the return before it was filed. In addition, certain of her actions-including the April 5, 2014 text inquiring about whether they should file a joint return, and her request for a filing extension-indicated that she did not know that one had been filed on her behalf. Overall, the Court found that she did not agree to file a joint return, was unaware of the contents of the return filed, and did not intend to be bound by the return filed by Victor.

Accordingly, the Court concluded that Victor's correct filing status for 2013 was married filing separately, and upheld the deficiency. However, the Court found that as of the filing date, Victor acted with reasonable cause and good faith and thus found him not liable for an accuracy-related penalty. He was married to Sharon during 2013, they had previously filed jointly, and she had suggested that they file a joint return. While subsequent events indicate that she did not actually agree to file a joint return for 2013, his assumption was nonetheless reasonable at the time that he filed.

Ervin, (DC KY 5/2/2017) 119 AFTR 2d ¶ 2017-725.

A district court has rejected IRS's argument that it was not obligated to refund the taxpayers' accuracy-related penalty, even though the taxpayers had received a jury verdict granting that refund because the taxpayers met the elements of the reasonable cause defense. IRS had argued that the fact that the taxpayers had received damages from their tax advisor after the jury verdict meant that the taxpayers would receive a double recovery if they also got the refund.

§6662 imposes the accuracy-related penalty for various offenses including valuation misstatements.

Under §6664(c)(1), an accuracy-related penalty under §6662 will generally not apply to any portion of an underpayment if it is shown that there was reasonable cause for that portion and that the taxpayer acted in good faith; both of those defenses can potentially be established by, among other things, reliance on the advice of a tax professional. (*U.S. v. Boyle,* (S Ct 1985) 55 AFTR 2d 85-1535)

The taxpayers, Mr. and Mrs. Ervin, invested in a tax shelter. The Ervins originally brought an action against IRS seeking a refund of the valuation misstatement penalty payments paid to IRS. The Ervins received a jury verdict in their favor, successfully proving the reasonable cause defense under §6664(c). As a result, the Ervins argued that they were entitled to a refund of the penalty payments from IRS.

In another action, the Ervins brought claims against certain tax advisors, and those claims were settled prior to the trial in this case. IRS argued that a refund would result in a windfall and double recovery since the Ervins had already received a large settlement from their tax advisors. The Ervins contended that they incurred about $18.5 million in loss as a result of their participation in the tax shelter, and the amount that they received in the prior settlements covered fees and costs, rather than the penalties paid.

The Ervins sought a judgment as a matter of law that they were entitled to a refund from IRS of the penalty payments. In response, IRS sought discovery in regards to the terms of the settlement and recourse for the Ervins' untimely disclosure of any materials that could possibly impact the amount of damages in this case. IRS asserted that this discovery request was warranted because IRS was unaware of any settlement prior to the disclosure about it in the course of trial. The Ervins contested these points and insisted they were entitled to a full refund regardless of the private settlement.

The court rejected the IRS's various arguments regarding the "double recovery" issue. It said that no additional discovery was needed. The Ervins did not fail to disclose a matter "bearing on the nature and extent of injuries suffered." This suit was about a refund of penalties paid. The Ervins prevailed. The refund was owed.

As a general principle, where a tax was erroneously assessed and collected by the government, the government is obligated to repay any amount so collected. As a result of the jury's verdict, the Ervins were entitled to a refund of the penalties collected by IRS. IRS had no right to withhold the amount or offset it in any way. This was not an ordinary suit where damages might be subject to offset. The court said that it could not find, and the parties did not point to, a single instance in which a court has excused the government's obligation to repay the improperly assessed and collected tax in a refund suit. The court said that it declined to do so here.

Fleischer, TC Memo 2016-238.

A financial consultant, rather than his S corporation, should have reported the income earned in his individual capacity under a representative agreement and broker contract for the years in issue.

While the first principle of income taxation is that income must be taxed to the person who earned it, courts have found that it's impractical to apply a simplistic "who earned the income?" test when the choices are a corporation and its service-provider employee. Instead, the question has evolved to one of "who controls the earning of the income?" For a corporation, not its service-provider employee, to be the controller of the income, two elements must be found: (1) the individual providing the services must be an employee of the corporation whom the corporation can direct and control in a meaningful sense; and (2) there must exist between the corporation and the person or entity using the services a contract or similar indicium recognizing the corporation's controlling position. (*Johnson,* (1982) 78 TC 882) The Eighth Circuit has noted that these elements can also be found in Regulation §31.3121(d)-1(c)(2). (*Sargent*, (CA 8 1991) 67 AFTR 2d 91-718, rev’g (1989) 93 TC 572)

Ryan Fleischer was a certified financial planner, a registered financial consultant, and a licensed seller of variable health and life insurance policies under State laws. He had a degree in business administration and obtained his security 65 licenses so that he could purchase and sell securities under the Securities Exchange Act of 1934, and the Financial Industry Regulatory Authority and the North American Securities Administration Association rules.

On February 2, 2006, Mr. Fleischer entered into a representative agreement with Linsco/Private Ledger Financial Services (LPL). The agreement expressly stated that his relationship with LPL was that of an independent contractor. He signed the agreement in his personal capacity.

On February 7, 2006, Mr. Fleischer incorporated Fleischer Wealth Plan (FWP) and had it elect S corporation status. Mr. Fleischer was the sole shareholder and the president, secretary, and treasurer of FWP.

On February 28, 2006, Mr. Fleischer entered into an employment agreement with FWP. The agreement expressly stated that his term of employment with FWP began on February 28, 2006. FWP did not enter into any other contracts other than this employment agreement during the years in issue.

On March 13, 2008, Mr. Fleischer entered into a broker contract with MassMutual Financial Group (MassMutual). The contract was between Mr. Fleischer and MassMutual, and Mr. Fleischer signed the contract in his personal capacity. The contract explicitly stated that there was no employer-employee relationship between Mr. Fleischer and MassMutual. There was no mention of FWP in the contract.

There were no addendums or amendments to either the LPL agreement or the MassMutual contract requiring those entities to begin paying FWP instead of Mr. Fleischer or to recognize FWP in any capacity.

For 2009, 2010, and 2011 (the years at issue), Mr. Fleischer reported taxable wage income of $34,851, $34,856, and $34,996, respectively, from FWP on his Form 1040. He attached a Schedule E to his Form 1040, reporting for 2009, 2010, and 2011 nonpassive income of $11,924, $147,642, and $115,327, respectively, from FWP. No amount was reported for self-employment tax, but he did claim a self-employed health insurance deduction. No Forms 1099 from LPL or MassMutual were attached to his returns.

For 2009, 2010, and 2011, FWP reported on its Form 1120S gross receipts or sales of $147,617, $289,201, and $266,292, respectively. It reported total expenses of $135,693, $141,559, and $150,965, respectively. It also reported ordinary business income of $11,924, $147,642, and $115,327, respectively. The amount of gross receipts or sales was calculated from the Forms 1099 that LPL and MassMutual issued to Mr. Fleischer. The Schedule K-1, Shareholder's Share of Income, Deductions, Credits, etc., that FWP issued to Mr. Fleischer reported the ordinary business income that it reported on its Form 1120S.

On audit, IRS determined that the gross receipts or sales FWP reported on its Forms 1120S should have properly been reported by Mr. Fleischer as self-employment income on Schedules C attached to his Forms 1040 for the years at issue.

The Tax Court concluded that the income from the LPL agreement and the MassMutual had to be reported by Mr. Fleischer, rather than his S corporation, FWP, for the years in issue.
The Court reasoned that there was no indicium for LPL to believe that FWP had any meaningful control over Mr. Fleischer as FWP had not been incorporated and no purported employer-employee relationship between FWP and Mr. Fleischer existed at the time he signed the representative

agreement with LPL. Moreover, there was no evidence of any amendments or addendums to the LPL agreement after FWP was incorporated.

Although FWP had been incorporated before Mr. Fleischer entered into the broker contract with MassMutual, FWP was not mentioned in the contract, and Mr. Fleischer offered no evidence that MassMutual had any other indicium that FWP had any meaningful control over him.

Accordingly, the Tax Court found that Mr. Fleischer failed to meet the second element of the control test outlined in *Johnson*-that there is a contract between the corporation and the service recipient recognizing the corporation's controlling position. As such was the case, the Court found that there was no need for it to analyze (and the Court made no decision with regard to) whether Mr. Fleischer was an employee of FWP. Therefore, Mr. Fleischer individually, not FWP, should have reported the income earned under the representative agreement with LPL and the broker contract with MassMutual for the years in issue.

Flume, TC Memo 2017-21.

The Tax Court has determined that a taxpayer was a U.S. shareholder of two corporations that were controlled foreign corporations (CFCs), that he controlled one of those corporations, and that therefore he was liable for penalties because he did not timely file Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations.

§6038(a)(1) imposes information reporting requirements on any U.S. person, as defined in §957(c), who controls a foreign corporation. A person controls a foreign corporation if he owns or constructively owns stock that is more than 50% of the total combined voting power of all classes of voting stock or owns more than 50% of the total value of shares of all classes of stock. (§6038(e)(2)) A U.S. person must furnish, with respect to any foreign corporation which that person controls, information that IRS may prescribe. (§6038(a)(1)) Form 5471 and the accompanying schedules are used to satisfy the §6038 reporting requirements. The Form 5471 must be filed with the U.S. person's timely filed Federal income tax return. (Regulation §1.6038-2(i))

The information reporting requirements prescribed in §6038(a)(1) also are imposed on any U.S. person treated as a U.S. shareholder of a corporation that was a CFC for an uninterrupted period of 30 days during its annual accounting period and who owned stock in the CFC on the last day of the CFC's annual accounting period. (§951(a)(1), §951(b), §6038(a)(4)) A U.S. shareholder, with respect to any foreign corporation, is a U.S. person who owns under §958(a), or is considered as owning under §958(b), 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation. (§951(b)) §958(b) provides constructive ownership rules that are based on §318.

§6046 requires information reporting by each U.S. citizen or resident who is at any time an officer or director of a foreign corporation, where more than 10% (by vote or value) of stock is owned by a U.S. person. (§6046(a)(1)(A)) The stock ownership threshold is met if a U.S. person owns 10% or more of the total value of the foreign corporation's stock or 10% or more of the total combined voting power of all classes of stock with voting rights. (§6046(a)(2)) A U.S. person who disposes of sufficient stock in the foreign corporation to reduce his interest to less than the stock ownership requirement is required to provide certain information with respect to the foreign corporation. (Regulation §1.6046-1(c)(1)(ii)(c)) The required reporting also must be on a Form 5471 that is filed together with a timely filed income tax return. (Regulation §1.6046-1(j)(1); Instructions to 2015 Form 5471)

Penalties are imposed for failure to meet the above requirements. (§6038(b), §6046(f), §6679)

The instructions for Form 5471 describe the categories of persons required to file Form 5471 and the information that each category of filer is required to provide. A category 3 filer is a U.S. person described in §6046(a)(1)(B). A category 4 filer is a U.S. person that controls a foreign corporation as described in §6038(a)(1) and §6038(e). A category 5 filer is a U.S. person that is a U.S. shareholder of a CFC as described in §6038(a)(4).

The taxpayer, Mr. Flume, was a U.S. citizen living in Mexico.

FFM was incorporated in Mexico in 1995 and owned a fast food franchise. Initially, FFM was owned 50% by Flume and 50% by Mr. Adams. Flume was president of FFM. The fast food franchise was sold in 1998, but FFM remained intact. FFM was a CFC during years 2001 and 2002. Flume owned 50% of FFM's stock for the entirety of 2001. On February 8, 2002, Flume sold a portion of his stock to Mr. Tornell, reducing his ownership to 9%. During the years in issue, Tornell was a Mexican citizen. Tornell was never an officer or a director of FFM.

In 2001, Flume and his wife incorporated Wilshire-Belize, a Belizean company. Wilshire-Belize issued two bearer shares, to Flume and his wife, resulting in each holding a 50% interest at the time of incorporation. Flume served as president and director, and his wife served as vice president. Wilshire-Belize's original articles of association were later amended to eliminate the two original bearer shares. The amended articles of association were backdated to April 12, 2001, to reflect the date of incorporation. Under the amended articles of association, Flume, his wife, and their daughter each held a 9% interest and Tornell held the remaining 73% interest in Wilshire-Belize.

On October 18, 2005, Flume and his wife opened an account with United Bank of Switzerland (UBS) under Wilshire-Belize's name (UBS account). Flume and his wife were the only individuals with signature authority over the UBS account.

When the UBS account was opened, Flume provided UBS with Wilshire-Belize's original memorandum and articles of association, a certificate of incumbency, and copies of the two bearer shares. The backdated amended articles of association were not provided to UBS. UBS's due diligence documents identified Flume and his wife as the beneficial owners of the UBS account and Flume as the sole owner of Wilshire-Belize. Flume controlled the UBS account investment activity.

Flume submitted delinquent Forms 5471 regarding his interests in FFM in 2013. He never reported Wilshire-Belize information on any Form 5471. IRS assessed penalties for Flume's failure to file Forms 5471 declaring his ownership interests in FFM during 2001 and 2002 and in Wilshire-Belize from 2001 through 2009.

Taxpayer was penalized with respect to both companies. The Court found Flume subject to the assessed penalties for failure to file Form 5471 with respect to both companies, as follows:

a. FFM. Flume was a category 5 filer for tax year 2001 because he was a U.S. shareholder who owned stock in a CFC for an uninterrupted period of 30 days or more during tax years 2001. FFM was a CFC throughout tax years 2001 and 2002. Flume owned 50% of the stock of FFM for the entire 2001 tax year and maintained his 50% ownership of FFM until February 8, 2002, when he sold 41% of his interest in FFM. Thus, under §6038(a)(4), Flume was required to file Form 5471 for FFM for tax year 2001.

Flume was required to file Form 5471 as a category 3 filer for FFM for tax year 2002. In 2002, Flume sold 41% of his original 50% shares, thereby reducing his ownership in FFM to less than 10%. Thus, under Regulation §1.6046-1(c)(1)(ii)(c), Flume was required to file Form 5471 because he reduced his ownership in FFM to less than 10% during tax year 2002.

Flume argued that his delinquent Forms 5471 for FFM for tax years 2001 and 2002 should have a retroactive effect and therefore no penalty should apply. The Court disagreed, stating that, under Regulation §1.6038-2(i) and Regulation §1.6046-1(j)(1), Flume was required to file a Form 5471 for FFM with his income tax returns on the date those returns were due.

b. Wilshire-Belize. Flume was a U.S. shareholder and controlled Wilshire-Belize, making him a category 4 and category 5 filer. As such, Flume was required under §6038 to file Forms 5471 for the years in issue. Therefore, IRS correctly assessed penalties under §6038(b) for Flume's failure to file Forms 5471 for Wilshire-Belize for each year from 2001 to 2009.

IRS determined that Flume and his wife each held a 50% interest in Wilshire-Belize during the years at issue. Flume argued that he did not have more than a 9% interest in Wilshire-Belize at any time; thus, he was not required to file Forms 5471 for Wilshire-Belize for the years in issue.

Flume asserted that the two bearer shares that gave him and his wife each a 50% ownership in Wilshire-Belize were eliminated and that the share ownership structure changed, reducing his ownership to 9% for the years in issue. To support this claim, Flume provided Wilshire-Belize's amended articles of association showing that he held a 9% interest. However, the backdated amended articles of association and the absence of any evidence as to when or if the change in stock ownership actually occurred contradicted Flume's assertion.

Flume was the president and a director of Wilshire-Belize. Flume and his wife each held a 50% interest in Wilshire-Belize at the time they incorporated it in 2001. In determining stock ownership of a foreign corporation to determine whether it is a CFC, the rules under §318(a) apply with modifications. (§958(b)) Under these rules, Flume constructively owned the 50% interest held by his wife. (§318(a)(1)(A)(i)) When this 50% interest was added to the 50% interest that Flume directly owned, he owned more than 50% of Wilshire-Belize. Thus, Wilshire-Belize was a CFC for the years in issue.

The Court said that the record showed that Flume retained his 50% ownership up to and including a portion of tax year 2005. On October 18, 2005, Flume opened the UBS account using the original articles of association and copies of the two bearer shares. Flume testified that he used these documents to open the bank account because they were all he had available.

The Court said that nothing in the record indicated a change in Flume's 50% ownership for tax years 2006 through 2009. Flume and his wife continuously directed investments into and out of the UBS account and were the only people with signature authority over the UBS account. Flume controlled the UBS account investment activity. Furthermore, Flume failed to precisely indicate when the reduction in ownership occurred or to sufficiently dispute the evidence that suggested that the change did not occur during the years in issue. Flume merely provided self-serving testimony and a backdated document to support his claim that he maintained only a 9% ownership interest during the tax years in issue.

Franklin, TC Memo 2016-207.

IRS's determination of construction-contracting S corporations' sole owner's unreported income for multiple years was upheld in part and rejected in part. Amounts reportable included interest payments, IRA distributions, various bank deposits, and discharged bank debt for year for which taxpayer did not prove insolvency. However, IRS failed to support its determination that corporation made constructive distribution in year when, before ceasing to operate, it failed to collect from taxpayer amount remaining on its books as shareholder loan. Notably, there was no evidence that corporation had E&P that year so as to support treating subject funds as dividend. And evidence otherwise indicated that loan occurred in year prior to that at issue.

Unless an S corporation has accumulated earnings and profits, no distribution of property (including money) by the corporation to a shareholder with respect to his stock will constitute a dividend within the meaning of §316(a). (§1368(b) and §1368(c)) Instead, distributions by an S corporation with no accumulated earnings and profits, to a shareholder with respect to his stock, are excluded from the shareholder's gross income to the extent that the distribution does not exceed the adjusted basis of the shareholder's stock. (§1368(b)(1)) Any excess is treated as gain from the sale or exchange of property. (§1368(b)(2))

An S corporation may have accumulated earnings and profits from a variety of sources, including: (1) as a carryover from years in which it was a C corporation, before it became as S corporation, see *Cameron,* (1995) 105 TC 380; and (2) as the result of certain reorganizations and the like, see §1371(c)(2).

Deductions and losses of an S corporation are passed through to shareholders and (except as otherwise limited by the Code) claimed on the shareholders' own returns. However, a shareholder can deduct his pro rata share of S corporation losses only to the extent of the total of his basis in (a) the S corporation stock, and (b) debt owed him by the S corporation. (§1366(d), Regulation §1.1366-2)

§6651(a)(2) imposes a penalty for failure to timely pay the amount of tax shown on a return, unless the taxpayer establishes that the failure was due to reasonable cause and not willful neglect.

If a taxpayer fails to file a return when required or files, willfully or otherwise, a false, fraudulent, or frivolous return, IRS can prepare a return based on its own knowledge and on information it obtains through testimony or otherwise. (§6020(b)(1) and Regulation §301.6020-1(b)(1)) Such an IRS-prepared return is sometimes referred to as a "substitute for return" (SFR). An SFR made by IRS under §6020(b)(1) and Regulation §301.6020-1(b)(1) and signed by IRS is good and sufficient for all legal purposes, except insofar as any federal statute expressly provides otherwise. (§6020(b)(2); Regulation §301.6020-1(b)(3))

The taxpayer, Mr. Franklin, was late in filing his 2007 and 2008 tax returns and paying the taxes due with those returns. He failed to file any returns for 2009 and 2010. IRS prepared Form 4340, Certificate of Assessments, Payments, and Other Specified Matters, that stated that, for both 2009 and 2010, IRS prepared an SFR.

Franklin owned all of the shares of FDI, a corporation in the construction business. FDI was incorporated on March 24, 1989 and elected S corporation status effective March 27, 1989.

FDI reported on Schedule L, Balance Sheet per Books, that was attached to its 2007 Form 1120S, an item, "Loans to shareholders," with an opening balance of $218,342 and an end-of-year balance of zero. In determining Franklin's 2007 deficiency, IRS made a positive adjustment of $218,342 to Franklin's reported 2007 gross income, on the grounds that Franklin had received that amount as a loan from FDI and, in 2007, FDI had discharged his obligation to make repayment. IRS treated the discharge as a constructive distribution to Franklin of $218,342, i.e., an ordinary dividend.

ACRO was during 2007 a creditor of FDI to which FDI was in default on indebtedness exceeding $1.7 million. Franklin had guaranteed that indebtedness, and ACRO demanded that he pay it. ACRO in 2007 seized and sold Franklin's personal assets worth $496,000 and applied the proceeds in partial satisfaction of his guaranty. Pursuant to the guaranty, he still owed ACRO $500,000.

The Court disagreed with IRS's position that Franklin had $218,342 of dividend income from FDI.

First the Court said that, given the 3-day period between its incorporation and S election, it was likely that FDI never accumulated earnings and profits as a C corporation. Moreover, although the record was silent, from the nature of its business as construction/contractor, it also seemed likely that it was never involved in reorganizations or other transactions referred to in §1371(c)(2). The Court found, accordingly, that FDI had no accumulated earnings and profits.

Then it said, having determined that no distribution to Franklin with respect to the $218,342 shown as a loan to shareholder on FDI's 2007 books could have been a dividend within the meaning of §316(a), it had to determine whether the elimination of that item from FDI's books by the end of 2007 gave rise to a constructive distribution to Franklin during 2007. The Court concluded that it did not.

If Franklin received $218,342 from FDI with no repayment obligation, then the payment may well have constituted a distribution to him with respect to his stock. To the extent the distribution exceeded in amount his adjusted basis in his FDI stock, he realized a gain on the sale or exchange of property. Because the $218,342 was recorded on the 2007 books of FDI as the opening balance of FDI's loans-to-shareholders account, the Court concluded that the associated payment (or payments) was (or were) made in a year before 2007. Since no year before 2007 was at issue, the Court said that it need not concern itself with whether Franklin realized a gain on account of the payment in a prior year. And it concluded that there was no constructive 2007 distribution.

The Court held that Franklin's basis in FDI was increased by the $496,000 but not by the $500,000.

ACRO seized and sold Franklin's property and applied the proceeds, $496,000, to FDI's indebtedness to it pursuant to Franklin's obligation as a guarantor. That gave rise to an indebtedness from FDI to Franklin in an equal amount. Franklin's basis in that indebtedness increased the limitation on the amount of FDI's losses and deductions that he could take into account.

The Court said that that was not the case with respect to the remaining $500,000 that Franklin claimed he guaranteed. It cited *Raynor,* (1968) 50 TC 762, for the rule that "[n]o form of indirect borrowing, be it guaranty, surety, accommodation, comaking or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay part or all of the obligation."

The Court held that no failure-to-pay penalties applied to 2009 and 2010 because IRS did not introduce sufficient evidence that tax was shown on a Federal income tax return for those years.

The Court said that, to carry its burden that imposition of a §6651(a)(2) penalty is appropriate, IRS must introduce evidence that the tax was shown on a Federal income tax return. (*Cabirac,* (2003) 120 TC 163) When a taxpayer has not filed a return, the §6651(a)(2) penalty may not be imposed unless IRS has prepared an SFR that meets the requirements of §6020(b). (*Wheeler,* (2006) 127 TC 200)

The Wheeler Court cited a list of cases in which the taxpayer failed to file a return and the failure-to-pay penalty was deemed to have been properly assessed; in each of those cases, the record included the SFRs that IRS contended met the requirements of §6020(b) and/or stipulations that the SFRs had been filed. In Wheeler, the record contained neither. The Wheeler Court stated: "The only evidence regarding the SFR is a cryptic and summary reference to a 'Substitute for Return' contained in Form 4340." The Wheeler Court held that that evidence was insufficient to show that IRS had made an SFR satisfying the requirements of §6020(b), that therefore the record did not contain evidence that the taxpayer failed to pay tax shown on a return, and that IRS failed to satisfy its burden of production.

Here, IRS produced evidence of Franklin's non-payment which Franklin did not dispute. IRS argued that, as a result, it produced sufficient evidence to show that the failure-to-pay penalties were appropriate.

But the Court said that IRS did not introduce into evidence any SFRs, nor had the parties stipulated that valid SFRs were made. And while Forms 4340 for 2009 and 2010 were in evidence-and each stated "substitute for return" and listed a corresponding date-following the rule of Wheeler, the Court found that the transcripts did not establish that the SFRs met the requirements of §6020(b). As a result, the record did not contain evidence that the taxpayer failed to pay tax shown on a return, and therefore the taxpayer was not liable for the failure-to-pay penalties.

Gaylor v. Mnuchin, (DC WI 10/6/2017) 120 AFTR 2d ¶ 2017-5355

A district court has held that the §107(2) exclusion for clergy housing (“parsonage”) allowance is unconstitutional because it violates the Establishment Clause of the U.S. Constitution.
A minister of the gospel can exclude from gross income: (1) the rental value of a home furnished to him, (§107(1)) or (2) the rental allowance paid to him as compensation, to the extent he uses it to rent or provide a home and to the extent the allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities. (§107(2))

Although the phrase “minister of the gospel” in §107 appears on its face to be limited to Christian ministers, IRS has interpreted the phrase liberally to encompass certain religious leaders of other faiths as well. In *Silverman,* (1972) 57 TC 727, the term was applied to persons holding equivalent status in other religions. In Rev Rul 78-301, 178-2 CB 103, the term was applied to those who perform “substantially all of the religious functions” of an ordained minister.
The parsonage allowance exclusion does not apply unless the housing is furnished as compensation for acting as a duly ordained, licensed, or commissioned member of the clergy. (Rev Rul 70-549, 1970-2 CB 16)

Under the Establishment Clause of the U.S. Constitution, Congress shall make no law respecting an establishment of religion.

Freedom from Religion Foundation, Inc. and its co-presidents Annie Laurie Gaylor and Dan Barker—the plaintiffs—brought suit in the district court to challenge §107(2) on the ground that it discriminates against secular employees and violates both the Establishment Clause of the First Amendment and the equal protection component of the Fifth Amendment.

As the district court noted, this was the second time that the foundation and its officers challenged §107(2).

In Freedom from Religion Foundation, Inc. v. Lew, (DC WI 11/21/2013) 112 AFTR 2d 2013-710, the district court concluded that the provision violated the Establishment Clause because it provided a benefit to religious persons and no one else, even though doing so was not necessary to alleviate a special burden on religious exercise. The district court found that the plaintiffs had standing to bring their suit because they could show that they suffered an injury in fact that was fairly traceable to defendants' conduct and capable of being redressed by a favorable decision. Specifically, the Code denied them an exemption that others received, and the injury was fairly traceable to the conduct of the defendants (Treasury Secretary Jacob Lew and the Acting IRS Commissioner Daniel Werfel) as those responsible for implementing the Code.

On appeal, the Seventh Circuit did not reach the merits of the case but instead vacated the judgment on the ground that the plaintiffs did not have standing to sue. The Seventh Circuit held that a person suffered no judicially cognizable injury merely because others received a tax benefit that was conditioned on allegedly unconstitutional criteria, even if that person was otherwise “similarly situated” to those who do receive the benefit. Only a person that had been denied such a benefit could be deemed to have suffered a cognizable injury, and because they never requested it, the plaintiffs were never denied the parsonage exemption . (*Freedom from Religion Foundation, Inc. v. Lew*, (CA 7 11/13/2014) 114 AFTR 2d 2014-6570,)

Plaintiffs, following the directions of the Seventh Circuit, took steps to obtain standing to again challenge §107(2). For tax years 2011 and thereafter, the Freedom from Religion Foundation has designated part of the salaries that Gaylor and Barker, who are married, received as a housing allowance. On an amended return, Gaylor and Barker sought a refund of their housing allowance for 2013. IRS granted the allowance for 2013 without explanation. On an amended return, they sought a refund of their 2012 housing allowance. In July of 2015, IRS disallowed the claim for 2012. A letter from IRS stated that individual taxpayers are allowed to claim deductions for housing on Schedule A if they have mortgage interest and property taxes, but that otherwise there is no deduction. In a response, Gaylor and Barker cited §107(2). In letters dated August 20, 2015, November 25, 2015, and January 12, 2016, IRS informed Gaylor and Barker that it was “working on” their amended return.

In April of 2016, plaintiffs filed this lawsuit. On June 27, 2016, IRS sent a letter to plaintiffs in which the examiner indicated that his review of the information previously submitted by the plaintiffs indicated their refund claim should be denied because the law “specifically requires that to exclude a housing allowance from income you must be a minister of the gospel.”

Since receiving that response, plaintiffs have filed amended returns for the 2014 and 2015 tax years in which they sought a refund of taxes paid on their designated housing allowances.

The question at issue was the constitutionality of §107(2), and its exclusion for a minister of the gospel of a rental allowance paid to him as part of his compensation. Can Congress give a subset of religious employees an income tax exemption for which no one else qualifies?

The district court granted summary judgment in plaintiffs' favor. The district court followed its earlier conclusion in Lew that §107(2) violates the Establishment Clause because it does not have a secular purpose or effect and because a reasonable observer would view the statute as an endorsement of religion. The court stated that any reasonable observer would conclude that the purpose and effect of §107(2) is to provide financial assistance to one group of religious employees without any consideration to the secular employees who are similarly situated to ministers.

Although the defendants (Treasury Secretary Steve Mnuchin, IRS Commissioner John Koskinen, and three church rectors who were allowed as intervenors) tried to characterize §107(2) as an effort by Congress to treat ministers fairly and avoid religious entanglement, the district court found that the plain language of the statute, its legislative history, and its operation in practice all demonstrated a preference for ministers over secular employees. Ministers receive a unique benefit under §107(2), and it is not, as defendants suggest, part of a larger effort by Congress to provide assistance to employees with special housing needs. A desire to alleviate financial hardship on taxpayers is a legitimate purpose, but it is not a secular purpose when Congress eliminates the burden for a group made up of solely religious employees but maintains it for nearly everyone else.

The court reasoned that Congress could have enacted a number of alternative exemptions without running afoul of the First Amendment. For example, Congress could have accomplished a similar goal by allowing any of the following groups to exclude housing expenses from their gross income: (1) all taxpayers; (2) taxpayers with incomes less than a specified amount; (3) taxpayers who live in rental housing provided by the employer; (4) taxpayers whose employers impose housing-related requirements on them, such as living near the workplace, being on call or using the home for work-related purposes; or (5) taxpayers who work for nonprofit organizations, including churches. Or some of these categories could be combined.

The district court found that the type of discriminatory treatment in §107(2) violates the Establishment Clause. The court noted that this conclusion made it unnecessary to consider plaintiffs' alternative argument that §107(2) violates the equal protection component of the Fifth Amendment.

Before reaching its decision, the district court resolved two potential objections to standing in plaintiffs' favor.

First, the court found that the plaintiffs did not bring the case too soon because IRS did not send Gaylor and Barker a rejection letter until after they filed their lawsuit. Standing is part of subject matter jurisdiction and subject matter jurisdiction must be present when a plaintiff files the lawsuit in federal court. In this case, denial of the refund claim was the injury that conferred standing. §6532(a)(1) permits the filing of a federal lawsuit to challenge a decision denying a refund after IRS renders a decision or the expiration of six months from the date of filing the claim. In this case, plaintiffs waited more than a year before filing a federal lawsuit. The court found that although §6532(a)(1) does not say so expressly, it is reasonable to construe the provision to mean that a claim is effectively denied if IRS does not render a decision within six months.

Second, the court rejected the intervenor defendants' contention that plaintiffs lack standing to seek an injunction or declaration because they produced no evidence suggesting that they will again be denied a refund in the future. A party seeking prospective relief generally must show a "significant" or "substantial" risk that she will be harmed again in the future. However, absolute certainty is not required. While IRS granting plaintiffs' 2013 refund may raise some doubt about future decisions, the court found that the decision denying Gaylor's and Barker's request for a refund was the more reliable indicator of the way that IRS would handle future requests. The denial was the more recent IRS decision, and it was the only decision in which IRS explained its reasoning.

Geneser, TC Memo 2017-110.

Nonemployee compensation of a former insurance salesman from renewal commissions, which the salesman had pledged as collateral for a loan and which was paid directly to the lender, was subject to self-employment tax. The Court found that the compensation did not qualify for exclusion from self-employment income under §1402(k) because it was dependent on his length of service with the insurance company. The Court also held that the salesman was not entitled to an interest expense deduction with respect to the loan because he failed to establish that it was business-related.

A taxpayer's self-employment income is subject to self-employment tax. Self-employment income is generally defined as the net earnings from self-employment derived by an individual from any trade or business carried on by such individual, less allowable deductions attributable to such trade or business. (§1402(a), §1402(b)) Gross income derived from an individual's trade or business may be subject to self-employment tax even when it is attributable in whole or in part to services rendered in a prior tax year. (Regulation §1.1402(a)-1(c))

However, under §1402(k), net earnings from self-employment does not include termination payments to insurance salespeople so long as, among other requirements, the payments do not "depend to any extent on length of service...performed for such company (without regard to whether eligibility for payment depends on length of service)."

§162(a) allows a taxpayer to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." §163(a) generally allows a deduction for any interest paid or accrued on indebtedness in the tax year. However, "personal interest," defined in §163(h)(2)(A) as any interest other than that "paid or accrued on indebtedness properly allocable to a trade or business," is nondeductible under §163(h)(1).

Larry Geneser sold insurance as an independent contractor for American Income Life Insurance Co. (AIL) from February 20, 1981, through October 4, 2007. During this time, he received commission advances from AIL, which created a debit balance and were repaid from his future earned commissions. Geneser and AIL entered into several contracts, one of which set out a vesting schedule for commissions that was dependent on an agent's length of service at AIL, including 100% vesting of commissions for agents that have completed 10 years of continuous service (which Geneser had).

On October 4, 2007, Geneser's debit balance with AIL was $1.2 million. He did not perform any services for AIL after this date. On December 19, 2007, Geneser entered a loan and security agreement with CFG LLC pursuant to which CFG lent $2.2 million to Geneser, who assigned all future earned commissions from AIL to CFG as collateral. The loan proceeds were disbursed as follows: $210,000 to CFG for the loan origination fee; $410,000 to repay another loan that Geneser claims was for his former office building; $1.2 million to AIL to repay his debit balance; and the remainder to Geneser.

In 2010, AIL reported $900,000 as nonemployee compensation to Geneser on Form 1099-MISC, Miscellaneous Income (it did not directly pay him any amount in 2010, but rather paid the renewal commissions to CFG pursuant to the loan agreement). Geneser did not file a return for 2010, so IRS prepared a substitute for return under §6020(b). On April 8, 2013, IRS sent Geneser a notice of deficiency for tax year 2010 that determined that he had $900,000 of nonemployee compensation and was liable for self-employment tax of $37,000.

Geneser challenged IRS's determination in the Tax Court, conceding that he received $900,000 in nonemployee compensation but asserting that such amount fell within the §1402(k) exemption from self-employment tax. Geneser also claimed that he was entitled to a $120,000 interest expense deduction, arguing that the commission advances from AIL and loan proceeds that he received personally were used solely to pay business expenses, and that repayment of the CFG loan in 2010 thus gave rise to deductible interest.

The Tax Court concluded that Geneser's commission payments credited toward his account in 2010 were dependent on his length of service at AIL and thus did not meet the requirements of §1402(k). It further noted that Geneser offered only self-serving testimony that, "apart from being neither convincing nor persuasive, [was] inherently incredible." Thus, Geneser could not exclude the $900,000 in commission payments from his net earnings from self-employment under §1402(a), and they were subject to self-employment tax under §1401.

The Court also found that Geneser failed to show that any of the any of the loan proceeds were used for business expenses. He testified that he made no attempt to distinguish between those advances and proceeds used to pay personal expenses and those used to pay business expenses and did not otherwise introduce any evidence that would allow the Court to make a reasonable allocation. He also did not offer any evidence to substantiate that the $410,000 loan repayment was actually for his former office building. Accordingly, the Court held that Geneser was not entitled to an interest expense deduction for 2010.

Goldsmith, TC Memo 2017-20.

In a case involving the demise of a law firm and its sole shareholder, an attorney who served prison time for tax crimes, the Tax Court largely sided with IRS and upheld its determinations with respect to, among other things, the firm's ability to deduct a payment related to the shareholder's residence and the imposition of penalties against the shareholder for failure to file and pay. However, in reaching a conclusion that was not argued by either side, the Court found that certain payments to the shareholder during the years at issue were nontaxable returns of capital, not wages as argued by IRS or loan reimbursements as argued by the shareholder.

§162(a) generally allows a deduction for ordinary and necessary expenses paid or incurred in connection with carrying on a trade or business. In deciding whether an expense is a deductible business expense, the Tax Court has consistently found that where a taxpayer's primary reason for an expense is personal, the expense is not deductible. (*Rehman,* TC Memo 2013-71)

The proper characterization of transfers by shareholders to corporations, as either loans or capital contributions, is made by reference to all the evidence, and the burden of proving that a transfer is a loan falls on the taxpayer. (*Dixie Dairies Corporation ,* (1980) 74 TC 476)

Courts have established a nonexclusive list of factors to consider when evaluating the nature of transfers of funds to closely held corporations. Such factors include, among others, the intent of the parties and the risks involved in making the transfers. (*Calumet Indus., Inc.,* (1990) 95 TC 257

The characterization of the inbound transfer can in turn inform the character of a subsequent transfer from the corporation to the shareholder (i.e., as repayment of a loan or as a return of capital).

Scott Goldsmith was an attorney and the owner/sole shareholder of a small law firm, Goldsmith & Associates (firm) that was treated as an S corporation for tax purposes.

By Mr. Goldsmith's own account, he did not have any background or education relating to accounting or operating a business, and this lacking was reflected in his firm. He did not keep sufficient accounting records, and for the first four months of the firm's existence, did not keep company funds in a corporate account.

The firm had a fair number of clients, but it mostly worked on contingency and began to pile up costs much more rapidly than receive offsetting fees. The firm had no credit and was unable to get a loan from a bank, so Mr. Goldsmith funded its operations by taking out mortgages on his personal residence. During the years at issue, he made at least thirteen advances to the firm, memorialized by contracts that detailed repayment terms and the consequences of a default. He poured money into the firm and did not always pay his personal bills, then one of the two mortgages on his residence went into default in 1999 and the house entered foreclosure.

In 2000, the firm received a large fee from an old case that settled. Mr. Goldsmith took the full amount as a distribution from the firm, used most of the fee to redeem his residence from foreclosure, and put what was left back into the firm. However, the firm soon did not have enough money to make payroll, and Mr. Goldsmith got multiple loans (at "loan-shark" interest rates), secured by his residence. His associates left the firm when it could not meet payroll.

By early 2002, Mr. Goldsmith had defaulted on all of the high-interest loans, and two creditors foreclosed on his residence. He was left with only redemption rights in the home, and, believing that he had equity in the home (which was worth about $1.5 million), contracted with Mr. Mitchell, another lender, on "yet harsher terms" in an effort to save it. Mr. Mitchell promised to use the redemption rights to buy the property and give Mr. Goldsmith a chance to buy it back later in exchange for $300,000 plus the cost of redemption ($600,000). Mr. Goldsmith testified that he was "on the hook" for a $300,000 payment, but the record was otherwise unclear as to whether (or how) he got the property back, and the only relevant loan documents were between Mr. Mitchell and a bank. After the deal closed (and Mr. Mitchell alleged to have paid certain closing costs), Mr. Mitchell held title to the property but let Mr. Goldsmith live there.

Mr. Goldsmith's law license was then suspended in 2004. In 2005, he was indicted under §7202 for failing to account for and pay over federal income and FICA taxes withheld from employees for the 1999, 2000, 2001, and 2002 tax years; and he was indicted under §7203 for failing to file individual income returns for those years. He pled no contest and was sentenced to 33 months imprisonment.

After Mr. Goldsmith was released, he and the firm were audited. The result was a notice of worker reclassification to the firm that determined Mr. Goldsmith was an employee, and a notice of deficiency to Mr. Goldsmith. In the notice of deficiency, IRS determined that the firm had gross receipts in years 1999 through 2002 totaling almost $1.7 million and that it was entitled to deduct business and automobile expenses of approximately $1.3 million for those years. (The firm operated at a loss in 1999, 2001, and 2002, and was profitable only in 2000 when it received the large fee from the old case.) The consequences of these determinations flowed through to Mr. Goldsmith.

The parties settled many issues before trial, and several others were deemed conceded based on Mr. Goldsmith's failure to argue during trial or on brief. A number of his claims also failed for lack of substantiation or a similar evidentiary failure. The issues that the Tax Court was left to decide included:

a. Whether the alleged closing costs and the alleged $300,000 payment out of the equity in Mr. Goldsmith's home to Mitchell are deductible by the firm;

b. Whether he received wages from the firm during the 1999 through 2002 tax years; and

c. Whether he owes additions to tax for failing to timely file and timely pay for 1999, 2000, and 2002.

With respect to the first issue, the Tax Court easily rejected Mr. Goldsmith's argument that the purported payment and closing costs relating to his residence should be deductible by the firm. Mr. Goldsmith claimed that the agreement with Mr. Mitchell was for the firm's benefit, noting that he had previously obtained a number of loans for the firm that were secured by his residence and asserting that the payments to Mr. Mitchell were really to pay off those loans. However, the Court agreed with IRS and found that these expenses were personal to Mr. Goldsmith and therefore could not be deducted by the firm under §162(a), even if the firm were to somehow indirectly benefit from the refinance. (Alternatively, the Tax Court found that these costs were entirely unsubstantiated.)

With respect to the next issue, IRS had determined that because Mr. Goldsmith was an employee of the firm-which Mr. Goldsmith conceded-payments to him from the firm during the years at issue were constructive wages in respect to which the firm owed payroll tax and he owed income tax. Mr. Goldsmith, however, claimed that the firm made no money during those years, so it could not have afforded to pay him wages and any money he took out of the firm was to reimburse him for expenses of the firm that he himself had paid earlier. The Tax Court noted its skepticism over IRS's determinations, which was somewhat shared with the agent who made these determinations, and ultimately determined based on all the facts that the payments were neither wages nor reimbursements but were a nontaxable return of capital to the extent of basis. In so holding, the Court cited a 2016 decision that "featured some freakishly similar facts"-*Scott Singer Installations*, TC Memo 2016-161. Like that case, the Court noted that Mr. Goldsmith's continued infusions of capital were not actually loans because, since the firm was failing, there was no real expectation for repayment.

Finally, the Court upheld IRS's imposition of additions to tax for failing to timely file a return and failing to timely pay tax shown on a return under §6651(a)(1) and §6651(a)(2). Mr. Goldsmith testified that he was clinically depressed during the years at issue, but the Court found that he was otherwise able to function and represent numerous clients per month, and that he otherwise failed to show that his disorder rendered him incapable of exercising ordinary business care. The Court also found that IRS prepared adequate substitutes for return under §6020(b)(2), which triggered the failure to pay penalty, and Mr. Goldsmith failed to offer any evidence that his failure was due to reasonable cause.

Hickam, TC Summary Opinion 2017-66.

A taxpayer, who brokered real estate mortgages and other loans, failed to show that he was a real estate professional for purposes of the passive activity loss (PAL) rules.

Accordingly, his rental real estate loss deductions for the years at issue were limited by the §469 PAL rules. However, the Court found that he was not liable for an accuracy-related penalty under §6662(a).

In the case of an individual, §469 generally disallows any current deduction for a passive activity loss. (§469(a)(1), §469(b)) Under §469(c)(1), the passive activity loss disallowance rules apply to any trade or business in which the taxpayer does not materially participate. In general, any rental activity is per se a passive activity regardless of the taxpayer's participation in the activity. (§469(c)(2))

However, under §469(c)(7)(B), the per se rule for rental activities does not apply to a qualifying real estate professional. A taxpayer qualifies as a qualifying real estate professional for a particular tax year if: (1) more than half of the personal services that the taxpayer performs during that year are performed in real property trades or businesses in which he materially participates; and (2) the taxpayer performs more than 750 hours of services during that tax year in real property trades or businesses in which he or she materially participates. §469(c)(7)(C) defines a real property trade or business for purposes of the real estate professional test as follows:

For purposes of this paragraph, the term "real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business."

In Chief Counsel Advice 201504010, IRS concluded that a real estate agent who brings together buyers and sellers of real property can be a so-called "real estate professional" who is engaged in a real property brokerage trade or business as described in §469(c)(7)(C) of the PAL rules. But, a mortgage broker who is a broker of financial instruments is not engaged in a real property brokerage trade or business.

Regulation §1.469-9(e)(1) states that a taxpayer who qualifies as a real estate professional can treat rental losses as nonpassive, but only if he or she materially participates. Regulation §1.469-9(e)(3)(i) confirms that even taxpayers who establish real estate professional status must separately show material participation in rental activities (as opposed to other real estate activities) before claiming any rental losses as nonpassive.

The extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means include, but are not limited to, the identification of services performed over a period of time and of the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries. (Regulation §1.469-5T(f)(4)) This regulation does not permit a post-event "ballpark guesstimate." (*Bailey,* TC Memo 2001-296)

A 20% accuracy-related penalty applies under §6662(a) where there is an underpayment attributable to negligence or disregard of rules or regulations. (§6662(b)(1)) The accuracy-related penalty does not apply to any portion of the underpayment for which the taxpayer shows that there was reasonable cause and that he acted in good faith. (§6664(c)(1)) Circumstances that indicate reasonable cause and good faith include reliance on the advice of a tax professional or an honest misunderstanding of the law that is reasonable in the light of all the facts and circumstances. (Regulation §1.6664-4(b))

During 2011 and 2012, Kurt Hickam brokered and originated mortgage loans for clients to buy real estate; refinance existing loans; and secure reverse mortgages, commercial loans, and, occasionally, construction loans. His duties also included overseeing one to three other independent contractors and working with processors or assistants on his client files. Occasionally, he would meet with an appraiser or inspect the condition of a property that was to secure a loan. Mr. Hickam did not operate, develop, redevelop, construct, reconstruct, or rent real estate in brokering mortgages or originating loans.

The company for which Mr. Hickam worked as a branch manager provided him with an office. Mr. Hickam's work hours were flexible, and he was not always required to perform his work at the office. During 2011 and 2012, Mr. Hickam did not record the amount of time he spent brokering mortgages and originating loans.

In addition to brokering mortgages and originating loans, Mr. Hickam managed and maintained three rental real estate properties (the three properties). Mr. Hickam met with prospective tenants, obtained their credit reports, called their references and prior landlords, and prepared their leases. After a tenant vacated a property or a unit, Mr. Hickam inspected the property or unit for damage.

He also periodically inspected the conditions of the three properties during the terms of the leases to see whether the properties had any damage or needed any repairs, spoke with the tenants and the gardeners, and ensured that garbage cans were returned to their appropriate locations after the garbage was collected. If a property or a unit sustained minor damage, Mr. Hickam would purchase the materials and perform the required repairs. If the property sustained major damage, he would seek bids, meet with contractors, and oversee the repairs.

On his 2011 and 2012 return's Schedule E, (Supplemental Income and Loss), Mr. Hickam reported his gross rental income and expenses for the three properties. In those Schedules E, he reported net losses for two of the properties and net profits for the third property. He claimed rental real estate loss deductions of $47,730 and $48,945 for 2011 and 2012, respectively, for the three properties. He also elected to treat the three properties as one activity.

Mr. Hickam did not keep contemporaneous records of the hours he spent or the services he performed with respect to the three properties. When IRS audited his 2011 and 2012 tax returns, he prepared a 2011 log of his hours and his services with respect to the three properties in response to the audit. He also prepared a 2012 calendar that contained entries in one-hour increments followed by a one or two-word phrase that referred to the three properties or Mr. Hickam's mortgage brokerage services and his loan origination services. (However, none of the phrases explained the services Mr. Hickam performed.)

At trial, Mr. Hickam testified that he had created the 2011 log and the 2012 calendars using leases, bank statements, checkbooks, bills, and receipts to reconstruct the amount of time he spent leasing, operating, and maintaining the three properties, but he did not present any of this corroborating evidence at trial. Mr. Hickam also testified that his accountant had suggested he estimate the amount of time for each activity performed, when he prepared the 2011 log and the 2012 calendars. Using the 2011 log and the 2012 calendars, Mr. Hickam testified that he had performed 1,583 and 1,200 hours of services in 2011 and 2012, respectively, with respect to his mortgage brokerage services and his loan origination services and 836 and 759 hours of services in 2011 and 2012, respectively, with respect to the three properties.

Mr. Hickam focused on the word "operation" in §469(c)(7)(C) and argued that his mortgage brokerage services and his loan origination services were performed in trades or businesses in real property operation because the underlying assets in both services were real property. He also argued that IRS erred in retroactively applying an IRS Chief Counsel Advice (CCA) issued in 2014- Chief Counsel Advice 201504010 -to disallow his 2011 and 2012 rental real estate loss deductions.

On the other hand, IRS contended that the Code was clear that mortgage brokerage and loan origination services were not real property trades or businesses. IRS argued that the CCA, rather than establishing a new interpretation of the law, correctly relied upon the statute.

The Tax Court found that Mr. Hickam failed to show that he was a real estate professional for 2011 or 2012. Accordingly, he could not deduct the rental real estate losses claimed on his 2011 or 2012 tax return under the §469(c)(7) real estate professional exception.

The Court, basing its conclusion on its interpretation of the Code and not on the CCA, determined that Mr. Hickam's mortgage brokerage services and loan origination services related to brokering and originating residential and commercial loans and not to the operation or brokerage of real property. Neither his mortgage brokerage services nor his loan origination services constituted real property trades or businesses for purposes of §469(c)(7)(C).

The Court reasoned that Mr. Hickam's argument that his mortgage brokerage services and his loan origination services were performed in trades or businesses in "real property operation" because the underlying assets were real property was too attenuated. His argument ignored the words "real property" that precede the specific activities listed in the statute; those words modify each of those activities, including "operation." Although the loans he brokered and originated were secured by real property, his mortgage brokerage services and his loan origination services did not involve operating the real properties that secured those loans. While Mr. Hickam's mortgage brokerage services constituted a "brokerage" trade or business, they did not constitute a "real property brokerage" trade or business: he did not broker real estate during either year at issue, rather, he brokered loans between buyers and financial institutions.

The Court determined that Mr. Hickam's rental real estate activity with respect to the three properties constituted a real property trade or business for 2011 and 2012. However, he failed to prove how much time he spent on his rental real estate activity during 2011 and 2012.

The Court, agreeing with IRS, found that his 2011 log and 2012 calendars were not reliable and so did not establish the amount of time Mr. Hickam dedicated to his mortgage brokerage services and his loan origination services or the three properties. They were prepared well after the years at issue with vague, nondescriptive entries and ballpark estimates of the time dedicated to the three properties.

Mr. Hickam did not provide any other credible evidence to support his testimony that he had performed 1,583 hours and 1,200 hours of services in 2011 and 2012, respectively, with respect to his mortgage brokerage services and his loan origination services and 836 and 789 hours of services in 2011 and 2012, respectively, with respect to the three properties. The Court noted that it was not required to accept unverified testimony of taxpayers in the absence of adequate documentation.

The Tax Court concluded that Mr. Hickam was not liable for an accuracy-related penalty under §6662(a) for 2011 or 2012. He relied in good faith on his accountant's recommendation and this reliance was reasonable cause for his underpayment of tax. The Court reasoned that the question of whether Mr. Hickam was a real estate professional was partially resolved on technical grounds-whether his mortgage brokerage services and loan origination services constituted real property trades or businesses under §469(c)(7)(C). Although the Court determined that neither service constituted a real property trade or business and notwithstanding his failure to maintain adequate records, the Court concluded that Mr. Hickam acted reasonably and in good faith in taking that position for the years at issue. Accordingly, he was not liable for an accuracy-related penalty.

Hargis, TC Memo 2016-232.

Where a husband was the co-borrower and/or guarantor of loans made by third parties to his S corporations, and the wife was a guarantor of loans to limited liability companies (LLCs) in which she was a member, there was insufficient evidence that those transactions resulted in an increase in the taxpayers' bases in the S corporations and LLCs. As a result, the taxpayers' losses from those entities were not deductible.

Deductions and losses of an S corporation are passed through to shareholders and (except as otherwise limited by the Code) claimed on their own returns. However, a shareholder may deduct his pro rata share of these passed-through items only to the extent of his adjusted basis in the S corporation stock, determined by taking into account the increases in basis for his share of the S corporation income during the year, and the decreases in basis for nondividend distributions for the year (§1366(d)(1)(A), plus his adjusted basis in any indebtedness of the S corporation to him. (§1366(d)(1)(B), Regulation §1.1366-2)

§704(d) limits the deductibility of a partner's distributive share of partnership losses. Those losses are deductible only to the extent of the adjusted basis of a partner's interest in the partnership.

A partner's adjusted basis in the partnership is essentially the partner's contribution to the partnership increased by the partner's distributive share of partnership income and decreased by all cash distributions and the partner's distributive share of partnership losses. (§705(a))

When a partner assumes the partnership's liabilities, the assumption of such liabilities results in a deemed contribution by the partner to the partnership and, consequently, increases the basis of the partner's interest in the partnership by the amount assumed. (§752(a); Regulation §1.752-1(b))

The taxpayers, Mr. and Mrs. Hargis (Husband and Wife), were Arkansas residents. Husband 100% owned several S corporations each of which operated several nursing homes (operating companies). Wife was a 25%-or-less owner of several LLCs that owned the real estate, facilities and equipment used in operating nursing homes and leased those assets to nursing home operators including Husband's operating companies.

The operating companies were financed by three types of debt: (1) loans received from the nursing home LLCs in which Wife held an interest (LLC loans), (2) loans received from Husband's other operating companies (intercompany loans), and (3) loans received from banks or institutions having no connection with the Hargises or the LLCs (commercial loans).

For all of the LLC loans and intercompany loans, and for some of the commercial loans, Husband signed the notes evidencing the loans in his individual capacity as a co-borrower along with his operating companies. With respect to those loans that Husband signed on as a co-borrower, proceeds were advanced directly by the lending entity to the co-borrowing operating company. To the extent payments became due on such loans, they were made by the operating companies and not out of the Hargises' personal account.

Wife was a member of Melbourne Properties, LLC (Melbourne Properties), which received a loan from Liberty Bank. Wife and the other members signed guaranty agreements as security for the Liberty Bank loan. The Liberty Bank loan agreement did not state that the loan would be recourse debt as to individual members of Melbourne Properties.

The Forms 1065, U.S. Return of Partnership Income, filed by Melbourne Properties for the tax years 2007, 2008, and 2009 did not report the amount of partnership liabilities existing at the end of each of those tax years and did not include analyses of partners' capital accounts. The Schedules K-1, Partner's Share of Income, Deductions, Credits, etc., issued to Wife for 2007 through 2009 did not report the amount of her share of partnership liabilities at yearend or give an analysis of her capital account at yearend.

Wife was also a member of Clay County, LLC (Clay County), which was one of seven co-borrowers on a loan from Bank of Oklahoma. The agreement did not state whether or how responsibility for the indebtedness was to be apportioned among the seven co-borrowers. Wife was one of the guarantors of the Bank of Oklahoma loan. The Bank of Oklahoma loan was not described in the loan agreement as being recourse, and the remedies provided for upon default did not include actions against individual members or shareholders of any of the borrowing entities.

The Form 1065 filed by Clay County for 2009 reported partnership liabilities from "Mortgages, notes, bonds payable" and gave an analysis of partners' capital account balances. The Schedules K-1 issued to Wife from Clay County for 2009 and 2010 provided calculations of Wife's capital account at the end of the tax years. The Schedules K-1 did not report the amount of her share of partnership liabilities for those years.

The Court held that none of the S corporations' debts increased Husband's basis in the S corporations.

The Court looked to case law for guidance. It said, citing *Bergman,* (CA 8 1999) 83 AFTR 2d 99-1882, that courts have consistently held that to increase his basis in an S corporation, a shareholder must make an "actual economic outlay."

§1366(d)(1)(B) contemplates a direct loan by the shareholder to the corporation using his own funds, or at least using funds for which he will be held ultimately responsible. (*Oren*, TC Memo 2002-172) Basis can be created where a shareholder borrows funds from a third party and then uses those funds to make a loan to the corporation (a "back-to-back" loan). (*Raynor,* (1968) 50 TC 762; *Miller,* TC Memo 2006-125) The shareholder can also increase his basis in the corporation by lending money that he has borrowed from another wholly owned entity, although in such a case the arrangement is eyed with scrutiny and the taxpayer bears the burden of demonstrating that a genuine indebtedness was created between himself and the related entity. (*Oren* (CA 8 2004) 93 AFTR 2d 2004-858; *Yates,* TC Memo 2001-280)

For basis to be created for a shareholder under §1366(d)(1)(B), the corporation's indebtedness must run "directly to the shareholder." (*Prashker,* (1972) 59 TC 172) No basis is created for a shareholder when funds are advanced to an S corporation by a separate entity, even one closely related to the shareholder. *(Bergman*) And, no form of indirect borrowing, be it guaranty, surety, accommodation, co-making or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay part or all of the obligation. (*Raynor*)

In this case, the loan transactions were structured so that the indebtedness of the operating companies ran directly from the operating companies to the lending entities. For all the loans at issue, the proceeds were advanced directly by the lending entities to the operating companies, and the notes executed by the operating companies were payable to entities separate from the Hargises. On the face of the notes, the operating companies were not indebted to the Hargises for anything; rather, Husband was listed as a co-borrower, and in some instances, a guarantor.

The Hargises argued that, under Arkansas State law, a co-borrower is "directly liable" for repayment and that his liability "is the same as if the loan were made to the borrower individually." The Hargises believed that the assumption of co-borrower's liability, which they said put Husband's own funds at risk, amounted to an economic outlay by Husband that should be treated, in effect, as indebtedness of the operating companies to him. But the Court said that that reasoning has been rejected by the Tax Court and other courts in prior cases. Those cases make clear that the bare potential for liability, without more, will not be considered a real economic outlay by a shareholder. See, e.g., *Estate of Leavitt,* (1988) 90 TC 206.

The Court said that the record revealed that Husband was never himself subjected to the burden of paying back the amounts borrowed by his operating companies. Husband testified at trial that there were no defaults on the loans and that he was never called on to make any payments on the loans personally. To the extent payments were made, they were made by the operating companies directly back to the lenders. Any interest paid by the operating companies on the indebtedness presumably was not reported as constructive dividends to the Hargises.

The Hargises also relied on *Selfe,* (CA 11 1985) 57 AFTR 2d 86-464, for the proposition that a shareholder's guaranty or co-making of a third-party loan to the corporation should be treated as an investment by the shareholder in the corporation where "the lender looks to the shareholder as the primary obligor." The Court said that the Hargises were, in effect, asking it to view Husband's co-making and guaranty arrangements constructively as back-to-back loans from the lenders to Husband and from Husband to the operating companies.

In the current case, none of the proceeds of the loan agreements entered into by Husband and his operating companies were ever advanced to Husband individually. The Court said that this distinction was critical. What initially happened in *Selfe* was a loan to the taxpayer directly, the proceeds of which she used to invest in her fledgling business. Only after that back-to-back transaction had taken place did the bank insist that the taxpayer refinance the line of credit in the name of the business.

None of the notes Husband signed as co-borrower or guarantor were collateralized by the Hargises' own property. The pledge of personal assets, which the Court found to be especially indicative of a real outlay by the taxpayer in *Selfe*, was not made by Husband here. Although the Hargises claimed that all of their assets served as security because "the practical effect of the pledge of his individually owned property versus signing an obligation to repay the loans individually is the same," they cited no legal authority supporting this assertion.

And, the Hargises provided no convincing evidence that any of the lenders looked to Husband as the primary obligor on the loans received by the operating companies. This was especially true with respect to the LLC loans and the intercompany loans, which generally lacked the indicia of genuine indebtedness.

The Court also held that neither the Liberty Bank loan nor the Bank of Oklahoma loan increased Wife's basis in the LLCs.

The only evidence that Wife provided was: a) evidence of the existence of the Liberty Bank loan and the Bank of Oklahoma loan; and b) Forms 1065 filed by Melbourne Properties and Clay County and Schedules K-1 issued to Wife from the two LLCs.

The Hargises did not provide any numeric computations of Wife's basis in Melbourne Properties and Clay County for the years in issue. The Forms 1065 filed by Melbourne Properties and the Schedules K-1 issued to Wife from Melbourne Properties for 2007 through 2009 did not report the total amount of partnership liabilities existing in those years and did not report the amount of partnership liabilities allocated to her. The Form 1065 for Clay County for 2009 did report some partnership liabilities, but a Form 1065 for Clay County for 2010 was not provided, and the Schedule K-1 issued to Wife from Clay County for 2010 did not report the amount of her share of partnership liabilities. None of these tax forms established that Wife had an increased tax basis in her membership interests on account of shares of the LLCs' liabilities.

The Court said that the Liberty Bank and Bank of Oklahoma loan agreements established at most that the LLCs incurred some amount of liabilities in the years those loans were made. The Hargises provided no further documentary evidence explaining how and to what extent the two loans affected Wife's basis in the two entities.

The Hargises' witness, Cooper, testified that liabilities of the nursing home LLCs were allocated among members according to their ownership percentages, and the Court said that this testimony generally supported the assertion that Wife should have been allocated some share of LLC liabilities on the basis of the Liberty Bank and Bank of Oklahoma loans. However, the Court said that the mere presence of the loan agreements and such generalized testimony did not allow it to determine Wife's correct basis in her membership interests for the years in issue.

Hardy, TC Memo 2017-16.

IRS could not group surgeon’s income from an LLC operating a surgery center (where he sometimes performed surgery) with the surgeon’s medical practice which was operated as a sole practitioner.

In general, under the PAL rules of §469, losses from passive activities may only be used to offset passive activity income. "Passive activity" means any activity (i) which involves the conduct of any trade or business, and (ii) in which the taxpayer does not materially participate.

A taxpayer may "group together," i.e., treat one or more trade or business activities or rental activities as a single activity (e.g., for determining material participation), if the activities are an appropriate "economic unit" for measuring gain or loss for PAL purposes based on all the relevant facts and circumstances. (Regulation §1.469-4(c)(1)). The five factors given greatest weight are: similarities and differences in types of business; the extent of common control; the extent of common ownership; geographical location; and interdependencies between or among the activities. (Regulation §1.469-4(c)(2))

Taxpayers can "use any reasonable method of applying the relevant facts and circumstances" to group activities, and not all of the five factors are "necessary for a taxpayer to treat more than one activity as a single activity." (Regulation §1.469-4(c)(2)) In general, once a taxpayer has grouped activities into appropriate economic units, the taxpayer must continue to use that grouping in subsequent tax years unless a material change in the facts and circumstances make it clearly inappropriate. (Regulation §1.469-4(e)) IRS may regroup a taxpayer's activities if any of the activities resulting from the taxpayer's grouping is not an appropriate economic unit and a principal purpose of the taxpayer's grouping is to circumvent the purpose of §469. (Regulation §1.469-4(f)(1))

An example in Regulation §1.469-4(f)(2) illustrates IRS's authority to re-group; it involves doctors who formed a partnership which they controlled but in which they did not martially participate. The doctors transferred medical equipment to the partnership in exchange for limited partnership interests and treated the partnership's services, which were provided almost entirely to patients of the doctor-partners, as an activity separate from their medical practices-effectively converting a portion of their practices' active income into passive income that could be offset by their unrelated passive losses. Under these facts, IRS found that the medical practice of each doctor and the interest in the partnership were an appropriate economic unit that should be treated as a single activity.

In a technical advice memorandum (TAM), PLR 201634022, a physician was a partial owner of a medical practice. The physician had a small ownership interest in an LLC classified as a partnership, which in turn held an interest in a surgery center also classified as a partnership. The surgery center provided surgery facilities for physicians. The physicians were not required to be owners of the practice, and they were not involved in the day-to-day management of the surgery center. Before the opening of the facility, the surgeries that could not be performed in the physician's practice were performed at a local hospital.

The physician in the TAM had passive activity losses and suspended losses. The physician treated the income from the LLC as passive and deducted the entire passive activity loss. In the TAM, IRS explained that these facts are distinguishable from those of the example in Regulation §1.469-4(f)(2). IRS looked at the fact that the physician and the surgery center provided different types of medical services. The physician had different ownership interests and control. IRS explained that there may be more than one reasonable method of grouping the taxpayer's activities into an appropriate economic unit. Likewise, IRS determined that the facts did not support a finding that the physician acquired his interest with a principal purpose of circumventing the underlying purposes of §469. Unlike the doctor in the example in the regulation, the physician in the TAM did not convert a portion of his practice into a single passive income generator by contributing equipment to a separate entity and leasing back the equipment at arm's-length rates. Thus, in PLR 201634022, IRS concluded that it did not have the authority to regroup the physician's interest into a single activity.

The taxpayers, Dr. and Mrs. Hardy, were a married couple who filed joint returns.

Dr. Hardy was a surgeon whose surgery practice, Northwest Plastic Surgery, was taxed as a sole proprietorship. If a procedure required general anesthesia, Dr. Hardy operated at a hospital. Because of the limited availability of operating rooms, however, Dr. Hardy struggled to obtain space at a hospital for the procedures.

MBJ was an LLC taxed as a partnership that was formed by a group of practicing physicians in 2004 for the purpose of operating a surgery center. MBJ was professionally managed. MBJ hired its own employees and did not share any employees with Northwest Plastic Surgery. Like hospitals, MBJ directly billed patients for facility fees. MBJ then distributed to each of its members his or her share of the earnings based on the facility fees less expenses. MBJ did not pay physicians for their procedures. Dr. Hardy received periodic distributions from MBJ, the amounts of which were not dependent on how many surgeries he performed at MBJ.

In 2006, Dr. Hardy purchased a 12.5% interest to join seven other practicing physicians in MBJ. Dr. Hardy never managed MBJ, and he had no day-to-day responsibilities there.

Mr. Kero, a CPA, prepared the Hardys' individual income tax returns for all years. For 2006 and 2007, the Hardys reported their MBJ income as nonpassive. Mr. Kero determined that the income from MBJ was nonpassive by relying on the Schedule K-1s from MBJ. The Schedule K-1s stated that the income was from a trade or business and included self-employment tax. Mr. Kero did not group Dr. Hardy's ownership interest in MBJ with Dr. Hardy's medical practice activity, and he did not consider the grouping regulations. The Hardys did not attach any statement reporting that they had grouped Dr. Hardy's ownership interest in MBJ with his medical practice activity. Both returns showed passive losses from activities that were not related to either Dr. Hardy's practice or MBJ and that were carried over to future years.

In 2008, Mr. Kero determined that the income from MBJ was passive, and he began reporting it as such. Mr. Kero learned that Dr. Hardy was not involved in the management of MBJ and was not liable for the debts of MBJ. However, because he did not believe the change would be material, he did not amend the Hardys' return for 2006 or 2007.

The Hardys filed their 2008-2010 returns on which they showed that the MBJ income was passive and offset that income with passive activity loss that included the passive loss carryovers from 2006 and 2007. IRS audited the 2008-2010 returns and disallowed the Hardys' passive activity loss offset for each of the audited years.

The court ruled the Hardys did not group Dr. Hardy's activities. IRS argued that the Hardys in effect grouped Dr. Hardy's ownership interest in MBJ with his medical practice into a single unit when it treated the MBJ income as nonpassive for 2006 and 2007; and therefore, under Regulation §1.469-4(e), they were precluded from changing that grouping for 2008-2010. The Court rejected this argument.

The Court would not infer that the Hardys grouped Dr. Hardy's ownership interest in MBJ with his medical practice. The mere fact that the Hardys reported Dr. Hardy's activity as nonpassive was not enough for the Court to find that they grouped Dr. Hardy's ownership interest in MBJ with his medical practice. Mr. Kero explained that he did not group the activities. He explained that he determined that the income from MBJ was nonpassive by relying on the Schedule K-1, which reported income from a trade or business and self-employment tax. Moreover, he stated that he did not consider Regulation §1.469-4. The Court found him credible. Accordingly, the Court held that the Hardys did not regroup their activities for 2008 when they began reporting the income as passive. They had consistently treated the activities as separate economic units.

The court also held that it was not appropriate for IRS to regroup. Then, IRS argued that it should be permitted to regroup the Hardys' activities to put Dr. Hardy's surgical practice income together with his MBJ income, under the rule of Regulation §1.469-4(f)(1), but the Court disagreed.

IRS argued that the Hardys' facts are almost identical to the facts of the example in Regulation §1.469-4(f)(2). It argued that, similar to the partnership in the example in the regulation, MBJ is owned by physicians, and MBJ provides services to their patients.

The Court held that the weight of the evidence supports treating the two sources of income as separate economic units. Dr. Hardy was the sole owner of his medical practice and only a minority owner of MBJ. Although he actively managed his medical practice, he did not have any management responsibilities in MBJ. He performed services different from MBJ's: Dr. Hardy was a surgeon providing care, and MBJ was a surgical center providing space and associated services. When patients decided to have procedures performed at MBJ, they separately paid a surgical fee to Dr. Hardy and a facility fee to MBJ. MBJ then distributed earnings from those facility fees, but the distribution was unrelated to whether Dr. Hardy performs surgeries at MBJ.

Additionally, the Hardys did not have a principal purpose of circumventing the underlying purposes of §469 when they treated the activities as separate. Unlike the taxpayers in the example in Regulation §1.469-4(f)(2), Dr. Hardy did not form an entity to generate passive activity losses. MBJ was already established when Dr. Hardy became a member. Moreover, Dr. Hardy was never able to perform procedures requiring general anesthesia at Northwest Plastic Surgery. Thus, he did not take a portion of his medical practice and convert it into a passive activity. It was clear that his purpose in joining MBJ was to create a cost-efficient alternative to a hospital procedure and not to generate passive activity losses. Accordingly, the Hardys' principal purpose was not to avoid the underlying purposes of §469.

The Court said that facts of this case were very similar to those presented in PLR 201634022. Although the TAM is not precedential, it showed that the Hardys' grouping was not clearly inappropriate.

Noting that, under §469(b), a taxpayer is entitled to a passive activity loss carryover only when there is an excess of passive losses over passive income, the Court held that the Hardys were not entitled to a carryover to 2008.

The Court noted that it had already concluded that Dr. Hardy should treat his ownership interest in MBJ as passive. "That leads us to the inescapable conclusion that the Hardys erroneously treated Dr. Hardy's income from MBJ as nonpassive for 2006 and 2007." The Hardys reported a total unallowed loss of $58,786 for 2006. For 2007 they reported unallowed losses of $119,615, which included the $58,786 carryover from 2006. The Hardys reported Dr. Hardy's distributions from MBJ of $279,988 and $199,121 as nonpassive for 2006 and 2007, respectively. Had the Hardys properly reported the MBJ income as passive for 2006 and 2007, it would have fully absorbed their passive losses, and there would have been no passive loss to carry forward to 2008. Accordingly, they were not entitled to any carryover to 2008.

Joe Alfred Izen, Jr., (2017) 148 TC No. 5.

Taxpayer was not entitled to a charitable deduction for his alleged gift to a charitable organization of his interest in an aircraft. He did not claim the deduction on his original return but rather on an amended return filed nearly six years after the contribution, and the documentation that he attached to his amended return was not a "contemporaneous written acknowledgement" (CWA) as required under §170(f)(12) and did not otherwise satisfy the statute's strict substantiation requirements.

For a contribution of a "qualified vehicle" (generally an auto, boat, or airplane), the claimed value of which exceeds $500, no deduction is allowed unless the taxpayer: (1) substantiates the contribution by a CWA from the donee organization containing specified information and certification(s); and (2) includes the CWA with the tax return on which the deduction is claimed. (§170(f)(12))

Where the donee organization has not sold the vehicle shortly after receiving it, §170(f)(12)(B) requires that the CWA include the following information:

1. The name and taxpayer identification number (TIN) of the donor;

2. The vehicle identification number or similar number;

3. A certification of the intended use or material improvement of the vehicle and the intended duration of such use;

4. A certification that the vehicle would not be transferred in exchange for money, property, or services before completion of such use or improvement;

5. Whether the donee organization provided any goods or services in exchange for the vehicle; and, if so,

6. A description and good-faith estimate of the value of such goods or services.

If the donee is required to make the certifications listed above, a CWA is considered to be contemporaneous if the donee organization provides it within 30 days of the contribution. (§170(f)(12)(C)(ii))

Any donee organization required to furnish a CWA as described above is required to provide IRS the information contained in the acknowledgment. Form 1098-C, Contributions of Motor Vehicles, Boats, and Airplanes, has been designated for this purpose. For gifts during calendar year 2010 (the year at issue), a donee organization was required to file Copy A of this form with IRS by Is February 28, 2011, and to provide the donor with Copies B and C of the form or with its own acknowledgement that contains the required information.

Joe Alfred Izen, Jr. timely filed his 2010 income tax return. It was examined, IRS determined deficiencies and penalties, and Izen challenged the disallowance in the Tax Court. He did not claim any charitable contribution deductions at that time.

In 2014, the Tax Court granted Izen's motion for leave to file an amended petition. He alleged in the amended petition that, on December 31, 2010, he had donated a 50% interest in a 1969 model Hawker-Siddley DH125-400A private jet (aircraft) to the Houston Aeronautical Heritage Society (Society), an organization exempt from tax under §501(c)(3). He had acquired his 50% interest in the aircraft in 2007 for $21,000. He alleged that his 50% interest in the aircraft had been appraised at $338,080, and that he was entitled to a charitable contribution deduction in that amount for 2010. A partnership that held the remaining 50% interest also contributed its interest to the Society at the same time.

On January 23, 2016, Izen filed a motion for partial summary judgment that he was entitled to a charitable contribution deduction for his alleged gift. The Tax Court denied that motion on March 9, 2016, finding that there existed several disputes of material fact, including whether he had secured from the Society and attached to his return a CWA and the value of his interest as of December 31, 2010.

On April 14, 2016, Izen filed a Form 1040X, Amended U.S. Individual Income Tax Return, for 2010, claiming for the first time a deduction of $338,080 for his alleged contribution. He included with this amended return: (1) an acknowledgment letter addressed to a partner in the partnership that owned the other 50% interest, dated December 30, 2010, and signed by the president of the Society; (2) a Form 8283 executed by the managing director of the Society dated April 13, 2016; (3) a copy of an "Aircraft Donation Agreement" allegedly executed on December 31, 2010, by the president of the Society but bearing no other signatures; and (4) an appraisal by Winston McKenzie dated April 7, 2011, opining that the fair market value of his 50% interest in the aircraft, as of December 30, 2010, was $338,080.

On May 27, 2016, IRS filed a motion for partial summary judgment, contending that Izen's charitable contribution deduction should be denied on the ground that he failed to satisfy the substantiation requirements of §170(f)(12). On July 19, 2016, Izen filed a renewed motion for partial summary judgment, urging that the defects previously discerned by the Court had been cured by his subsequent filing of the 2010 amended return and that his claimed charitable contribution deduction should be allowed in full.

The Tax Court denied Izen's motion for summary judgment, finding that there were still disputes of material fact that included, among other things, the value of the aircraft when it was contributed. The Court questioned whether a 50% interest in a 40-year-old aircraft that had been purchased three years earlier for $21,000 was really $338,080.

The Court then determined that IRS was entitled to partial summary judgment, finding that Izen failed to include with his amended return a CWA that satisfied the requirements of §170(b)(12)(B). He did not include a copy of Form 1098-C with his return, apparently because the Society did not complete or file one in connection with the gift. And the letter that he did include from the Society failed to satisfy §170(f)(12)(B) because it was not addressed to him and did not acknowledge that he made a gift. It also did not include his name or TIN, and it did not include a statement as to whether any goods or services were provided in consideration of the gift.

The Court also considered whether the "Aircraft Donation Agreement" could satisfy the substantiation requirements of §170(f)(12). The Court noted that a deed of gift has been held to serve as a de facto CWA under §170(f)(8) (i.e., the somewhat less stringent substantiation requirements that apply for gifts of $250 or more) if it's contemporaneous and contains all requisite information. (*RP Golf, LLC,* TC Memo 2012-282) The Court then found that, even if the same principle were to apply in cases decided under §170(f)(12), the agreement in this case was insufficient. It was not fully executed as it had not been signed by either of the donors, and it did not contain Izen's TIN.

Izen argued that the TIN requirement should be considered met because the agreement was submitted with his amended return, which did have this information, citing Irby, (2012) 139 TC 371, for the principle that a CWA may be "made up of a series of documents." The Court, however, rejected this argument for several reasons. First, Congress knew that a CWA would accompany a return that included that taxpayer's TIN but nonetheless required that a TIN be included on the CWA itself, and that requirement would be surplusage if Izen's argument were accepted. And, in any event, the Court found that the agreement was not "contemporaneous" under §170(f)(12)(C) because, even if the Court were to allow the TIN on the amended return to satisfy that requirement, it was not provided within 30 days of the contribution. Izen did not file his amended return including his TIN until April of 2016, and he cannot rely on a 2016 document to cure the defects of a "contemporaneous" 2010 agreement. And finally, the agreement did not contain a certification of the intended use of the aircraft and intended duration of such use.

Izen also argued that the above defects should be excused on the ground that he substantially complied with the statutory requirements. However, the Court found that it has repeatedly rejected the application of the substantial compliance doctrine to §170(f)(8), and that §170(f)(12), like §170(f)(8), expressly provides that no deduction is allowed if the strict substantiation requirements are not satisfied.

Keeter, TC Summary Opinion 2017-36.

In a Summary Opinion, a taxpayer's military disability retirement income was excludable from income under §104(b)(2)(D), which provides for such exclusion if the taxpayer can demonstrate that he would be entitled, upon application to the Veterans Administration (VA), to receive disability benefits.

Pensions and retirement income are included in gross income unless otherwise excluded. (§61(a)(11), Regulation §1.61-11(a))

Military retirement pay falls under the definition of retirement income. (*Wheeler,* (2006) 127 TC 200) However, with certain limitations, military retirement payments may be excluded from gross income if they constitute amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces. (§104(a)(4)) In particular, under §104(b)(2)(D), the exclusion would apply if, on application for such, the taxpayer would be entitled to receive disability compensation from the VA.

IRS and the taxpayer, Kent Keeter, disputed whether he would have qualified under the VA's application of the Veterans Affairs Schedule for Rating Disabilities (VASRD). Keeter directed the Court to his testimony that he understood, after meeting with a VA representative at the time of his honorable discharge that he would have qualified for benefits. On the other hand, IRS contended that the Court should examine the VA standard and apply it to the taxpayer with the hindsight of knowing that, after he was honorably discharged, he had a career in computers.

Kent Keeter began service with the U.S. Army on January 19, 1984. While in training he sustained a head injury that required a two- to three-month hospital stay and led to a seizure disorder. He was placed on the Temporary Disability Retired List on June 7, 1984, with a disability rating of 40%.

Approximately one year later he was reevaluated at a military base and placed on permanent disability. Keeter was permanently retired at his then-current grade on July 9, 1985 with an honorable discharge. About that time, he met with representatives of the VA as well. Keeter understood then that he would qualify for disability benefits from the VA, but he did not apply.

After his discharge from the Army, Keeter resumed the college education that he had begun before enlistment, graduating with a degree in computer science. He worked in that field ever since.

In 2012, Keeter received disability retirement income of $5,936 from the U.S. Army that he did not report as income.

On December 29, 2014, IRS determined a deficiency of $1,666 in Keeters's tax for 2012.

The Tax Court held that Keeter's military disability retirement income of $5,936 was excludible from his gross income.

The Court reasoned that, while the military and the VA apply the same rating standard-the VASRD, which is set out in 38 C.F.R. pt. 4 (2012)-each approaches the question of disability ratings from a different perspective (see *Stine v. U.S.,* (2010) 92 Fed. Cl. 776, 795). While the military uses the VASRD to determine what compensation the service member is due for the interruption of his military career, the VA is more holistically examining the individual's ability to engage in civilian employment.

The Court stated that it declined IRS's invitation to put itself in the shoes of the VA today and instead it based its holding on the information that the taxpayer had at the time, which was that he would qualify for VA benefits.

Keeter's testimony was sufficient to establish that the VA would have awarded him disability compensation at the time of his discharge. While the parties did not produce evidence of the specific ratings for seizure disorders, the Court believed that should not bar the taxpayer from excluding any of his disability pay from gross income. And while the Tax Court noted that in another Summary Opinion (*Sana,* TC Summary Opinion 2015-72), in the absence of objective evidence regarding the taxpayer's physical condition, it had declined to accept the taxpayer's testimony that he was "certain" that he was entitled to VA benefits, the Court found that-aside from the fact that a Summary Opinion was not precedent under §7463(b) -the facts of Sana were distinguishable; here, Keeter met with VA representatives and credibly testified as to his understanding that he would qualify.

In deciding this case, the Tax Court also noted in passing that, for two prior tax years, Keeter had filed petitions for redetermination challenging IRS's inclusion of his disability retirement income for those prior years. In each case, the Court entered stipulated decisions in Keeter's favor. While

Keeter questioned why IRS continued to challenge the same issue, the Court did not conclude that he was arguing that IRS was estopped from challenging his tax treatment. The Court further noted that such an argument would be useless because it was well settled that each tax year stands on its own.

Lewis, TC Memo 2017-117.

Minister and author was not entitled to deduct his expenses under §162 because he was not engaged in a trade or business for profit. In addition, he was not allowed any deductions under the §183 hobby loss rules because he had no gross income from the activities for the year at issue.

Under §162(a), a taxpayer can deduct all ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. A trade or business expense is ordinary if it is normal or customary within a particular trade, business, or industry. It is necessary if it is appropriate and helpful for the development of the business.

The Supreme Court concluded that to be engaged in a trade or business within the meaning of §162, "the taxpayer's primary purpose for engaging in the activity must be for income or profit." (*Groetzinger,* (S Ct 1987) 59 AFTR 2d 87-532)

Taxpayers are also required under §6001 to substantiate their claimed deductions. In addition, under §274, heightened substantiation requirements apply to: (a) any traveling expense, including meals and lodging away from home; (b) any item with respect to an activity in the nature of entertainment, amusement, or recreation; (c) any expense for gifts; or (d) the use of "listed property," such as passenger automobiles.

The taxpayer must substantiate the following items with respect to expenses deductible under §274, by adequate records or by sufficient evidence corroborating the taxpayer's own statement: (1) the amount of the expense; (2) the time and place of the travel, use of the property, etc.; (3) the business purpose of the expense, and (4) the business relationship to the taxpayer. (Regulation §1.274-5T(c)(1), Regulation §1.274-5T(c)(2))

Under the §183 hobby loss rule, deductions attributable to a "not for profit" activity are allowed only to the extent of income from it, or to the extent deductions are allowable regardless of any profit-seeking motive, whichever is larger. (§183(b), Regulation §1.183-1) All facts and circumstances must be considered in the determination of whether a taxpayer has a profit objective. (Regulation §1.183-2(b))

§6662(a) and §6662(b)(1) impose a 20% penalty on the portion of an underpayment of tax that is attributable to negligence or disregard of rules or regulations. The accuracy-related penalty does not apply with respect to any portion of the underpayment for which the taxpayer shows that there was reasonable cause and that he acted in good faith. (§6664(c)(1))

During the year at issue, Mr. Willie Lewis was a minister and an author who occasionally performed weddings, attended meetings, and conducted seminars.

He timely filed a Federal income tax return for 2011 reporting unreimbursed employee business expenses on Schedule A, Itemized Deductions.

On audit, IRS issued a notice of deficiency for $1,681, disallowing the deductions for the business expenses and determining an accuracy-related penalty of $336 under §6662(a).

The Tax Court found that Mr. Lewis was not engaged in a trade or business for profit under §162. Accordingly, the deductions attributable to his ministry and book writing activities were limited to the gross income he derived from such activities under §183. However, because Mr. Lewis derived no gross income from those activities in 2011, he was not entitled to any deductions.

The Court noted that Mr. Lewis offered no credible evidence to establish a profit motive for his ministry and book writing activities. In fact, he admitted at trial that he "did not charge" for services he performed as a minister. Similarly, he did not provide evidence showing that he had any income from his alleged book writing activity.

In addition, he produced no accounting records, bank statements, invoices, or any other records traditionally associated with a business operating for a profit. Instead, he merely submitted credit card statements and a summary showing certain expenses. He also submitted a questionable employment contract with Goodnews Ministries which stated that he would be compensated $1 per year for his services. Mr. Lewis did not testify or otherwise offer credible evidence that he was actually paid the $1 or any other amount.

The Court concluded that even if Mr. Lewis were found to have engaged in a trade or business for profit, it would find that he failed to substantiate the expenses underlying their claimed deductions. Most of his claimed expenses included automobile and travel-related expenses which were subject to the strict substantiation under §274(d).

To deduct such items, the taxpayer must substantiate through adequate records or other corroborative evidence the amount of the expense, the time and place of the expense, and the business purpose of the expense. A taxpayer satisfies the "adequate records" test if he maintains an account book, a diary, a log, a statement of expense, trip sheets, or similar records prepared at or near the time of the expenditures that show each element of each expenditure or use. However, Mr. Lewis supported the claimed deductions with credit card statements, a spreadsheet generally itemizing the credit card charges, and a spreadsheet listing events he attended through April of 2011 with the corresponding mileage, meal expenses, and hotel expenses related to the events.

The Tax Court found that the taxpayer's summary schedule-which was created well after the expenses were incurred-was not an adequate record for purposes of §274(d). It was not maintained at or near the time of any expenditures, nor did it include their business purposes. Further, the summary schedule was incomplete since it failed to include events attended and expenses incurred after April of 2011. In addition, Mr. Lewis did not offer credible testimony or other evidence explaining how the charges on the credit card statements related to any specific business purpose.

The Court determined that to the extent Mr. Lewis' credit card statements reflect expenses not subject to strict substantiation, he had failed to specifically identify which of the numerous expenses he was claiming as deductions. He similarly failed to demonstrate why any of the expenses were ordinary and necessary business expenses.

The Court held that Mr. Lewis was liable for a §6662(a) accuracy-related penalty for negligence and disregard of the rules and regulations. IRS met its burden of production in establishing the appropriateness of the penalty: Mr. Lewis did not maintain sufficient records to support the expenses underlying his deductions, and the disallowed deductions were directly attributable to his failure to maintain adequate records. Moreover, Mr. Lewis did not offer any evidence that he had reasonable cause for his failure to maintain adequate business records or for his improper deductions. On the contrary, he testified that he had previously been a return preparer for "one of the major companies" which showed that he should have been aware that he was required to support his deductions with adequate records.

Liljeberg, et al, (2017) 148 TC No. 6.

Nonresident aliens who were full-time students at foreign universities and who participated in a summer work-travel exchange program were not "away from home in pursuit of a trade or business" and thus could not deduct their travel and living expenses under §162(a). However, the Court held that their travel insurance costs may be deductible under §213(a).

Under §871(b)(1), a nonresident alien individual engaged in a U.S. trade or business at some time during the tax year is subject to U.S. tax on taxable income that is effectively connected with the conduct of a U.S. trade or business; such income includes income from performance of personal services within the U.S. (§864(b)) Aliens present in the country on J visas, among other visa categories, are treated for §871 purposes as nonresident alien individuals engaged in a trade or business within the U.S., regardless of whether they are so engaged. (§871(c))

For nonresident alien individuals, deductions are allowed "only if and to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States." (§873(a)) While §262(a) precludes a deduction for personal, living, or family expenses, "traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business" may be deductible. (§162(a)(2))

For an expense to qualify under §162(a)(2), it must (1) be ordinary and necessary, (2) have been incurred while the taxpayer was "away from home," and (3) have been incurred in the pursuit of a trade or business. (*Barone*, (1985) 85 TC 462) The Tax Court has defined "home" for this purpose as meaning "the vicinity of the taxpayer's principal place of employment and not where his or her personal residence is located." (*Mitchell,* (1980) 74 TC 578) The Tax Court has further explained that the purpose of the away-from-home requirement "is to mitigate the burden of the taxpayer who, because of the exigencies of his trade or business, must maintain two places of abode and thereby incur additional and duplicate living expenses." (*Kroll,* (1968) 49 TC 557) Expenses associated with maintaining a residence far from one's principal place of employment for personal reasons, on the other hand, are not deductible. (*Tucker,* (1971) 55 TC 783) Nonetheless, a taxpayer may claim his personal residence as his home where he is away from home on a temporary, rather than indefinite or permanent, basis. (*Kroll*)

§213(a) allows the deduction of medical expenses, including amounts paid for health insurance, to the extent such expenses exceed 10% of a taxpayer's adjusted gross income and are not compensated for by insurance or otherwise.

Richard Liljeberg is a nonresident alien who, in 2012, was a full-time student in a foreign university who participated in the U.S. Department of State Summer Work Travel Program (SWTP). The purpose of the SWTP is "to provide foreign college and university students with opportunities to interact with U.S. citizens, experience U.S. culture while sharing their own cultures with Americans they meet, travel in the United States, and work in jobs that require minimal training and are seasonal or temporary in order to earn funds to help defray a portion of their expenses." Foreign nationals may participate in the SWTP for no longer than four months during the break between academic years.

Observation: This Tax Court decision also involves two factually similar cases with other foreign students who participated in the SWTP, which were consolidated with the instant case.

When the petition in his case was filed, Liljeberg lived in, and was a citizen of, the Republic of Finland. During 2012, he was a full-time student at the Haaga-Helia University of Applied Sciences in

Helsinki, Finland. He lived with his mother before he came to the U.S. in 2012, but, upon his return to Finland, he lived alone in a rental home. Throughout 2012, Liljeberg held a driver's license issued in Finland, owned a car in that country, and was registered to vote there. He also received mail and owned a bank account in Finland. In addition to school, he had a job in Finland before coming to the U.S. but did not return to that job upon his return.

Pursuant to the SWTP, Liljeberg was in the U.S. from May 21, 2012 through September 15, 2012. During most of his time in the U.S., Liljeberg worked as a lifeguard in Wisconsin, where he earned $4,404 in wages. Upon concluding his employment, but before his return to Finland, he traveled to Chicago, Washington, D.C., and New York City. He has not returned to the U.S. since.

Liljeberg filed a Form 1040NR, U.S. Nonresident Alien Income Tax Return, for 2012, deducting $1,700 in unreimbursed employee expenses-specifically, $995 for airfare to and from the U.S., $500 for the cost of the SWTP, $35 for the cost of his J visa, and $170 for health insurance in connection with his participation in the SWTP. IRS issued Liljeberg a deficiency notice denying his claimed deductions for travel and living expenses and determining a $54 deficiency.

The parties agreed that the U.S.-Finland treaty did not relieve Liljeberg of his tax liabilities, that he was taxable in the U.S. on the income earned here, and that he was engaged in a U.S. trade or business. However, they disagreed as to whether Liljeberg was entitled to deduct certain expenses paid traveling to and from the U.S. and to participate in the SWTP.

Liljeberg argued that he was a resident and citizen of Finland in 2012 and was in the U.S. to work a temporary job as part of an exchange program. The terms of his visa limited his stay in the U.S. to four months and he was required to "maintain" his residence abroad. This requirement, he argued, meant that he was "away from home" for §162(a) purposes. Other facts, such as maintenance of a driver's license and voter registration, similarly supported his intent to return and that his "tax home" was in Finland. Thus, Liljeberg claimed that he was engaged in the temporary business of being an employee in the U.S. and should be allowed to deduct his ordinary and necessary business expenses while being away from home.

Liljeberg also contended that a portion of his deducted expenses (e.g., visa, program fees, insurance) were not travel expenses and were not subject to the "away from home" requirement. Additionally, he claimed that the insurance cost was not only in furtherance of his trade or business, but was strictly required as a condition of procuring a visa and participating in the SWTP and acquiring employment thereunder.

IRS, on the other hand, argued that Liljeberg had a principal place of business in the U.S. at the location of his summer job, such that his tax home for purposes of §162 was in the U.S. Further, IRS pointed out that pursuing an education full-time does not constitute a trade or business under §162 (*Paul,* TC Memo 1980-147), so Liljeberg did not have a tax home in Finland. Therefore, reasoned IRS, because he was never away from his home in the pursuit of a trade or business, he cannot deduct "away from home" costs. IRS also disagreed with Liljeberg's argument that the temporary nature of a job eliminates the need for a business reason to maintain a separate personal residence, and further found that allowing him to deduct travel expenses relating to his summer job "would create a rule affording nonresident aliens a deduction to which domestic taxpayers are not entitled."

Finally, IRS pointed to the purpose of the "away from home" provision and noted that Mr. Liljeberg failed to present any evidence that he incurred any expenses related to his Finnish residence. Finally, with respect to the travel health insurance deduction, IRS found that the expenses are deductible not under §162 but under §213(a), subject to a 10% floor.

IRS conceded that Liljeberg was entitled to deduct under §162 his visa fees and his SWTP participation fees as unreimbursed employee expenses, subject to the 2% floor on miscellaneous itemized deductions. The Court noted that it accepted the concession on the basis of judicial economy "without expressing an opinion as to its correctness."

The Tax Court found that Liljeberg was not "away from home" for purposes of §162(a)(2), and thus could not deduct these expenses, except to the extent that his travel health insurance expenses satisfied the requirements of §213.

The Tax Court, looking at Supreme Court cases construing immigration law, found that the visa requirement to maintain a "residence" abroad means simply that the individual must intend to return "home" to his foreign country and not immigrate permanently to the U.S.-not that the individual literally maintain, and the duplicate living costs of, a second abode. And, the Court found that no evidence was presented that SWTP participants were required to maintain a second abode in their home countries. So, expenses so incurred (if any) were a personal choice and not a requirement. Accordingly, IRS properly denied his deductions for travel expenses paid in connection with the SWTP.

The Tax Court also agreed with IRS that the health insurance expenses were deductible under §213(a), to the extent they exceed 10% of adjusted gross income and were not compensated for by insurance or otherwise. The Court found that, notwithstanding the fact that Liljeberg was required to carry insurance as a condition of participating in SWTP, health maintenance costs have consistently been held to be personal in nature and deductible only under §213(a).

Lock, TC Summary Opinion 2017-10.

In a Summary Opinion, a taxpayer who worked in Iraq providing security for visiting dignitaries was not entitled to the §911 foreign earned income exclusion because his place of abode was the U.S. Additionally, the Court held that his former spouse was entitled to innocent spouse relief under §6015(c), leaving him on the hook for all the deficiencies relating to the improperly excluded foreign earned income.

§911(a) provides that a qualified individual may elect to exclude from gross income, subject to limitations in §911(b)(2), his foreign earned income. To be entitled to this exclusion, a taxpayer must satisfy two requirements, one of which is that he must be an individual "whose tax home is in a foreign country." (§911(d)(1))

§911(d)(3) provides that the term "tax home" means, in the case of an individual, "such individual's home for purposes of section 162(a)(2)." Under §162(a)(2), a person's home is generally considered to be the location of his regular or principal place of business. (Mitchell, (1980) 74 TC 578)

However, §911(d)(3) also provides that "[an] individual shall not be treated as having a tax home in a foreign country for any period for which his abode is within the U.S."

The term "abode" has a domestic connotation that stands in contrast to the taxpayer's principal place of business. (*Bujol,* TC Memo 1987-230, aff'd (1988, CA5) 842 F2d 328 (unpublished)) In determining the taxpayer's abode under §911(d), the Tax Court evaluates the taxpayer's domestic ties (i.e., his familial, economic, and personal ties) to the U.S. with his ties to the foreign country in which he claims a tax home during a particular period. (See. e.g., *Harrington,* (1989) 93 TC 297)

In general, if marrieds file a joint return, each spouse normally is jointly and severally liable for the entire tax due. However, if certain requirements are met, an individual may be relieved of joint and several liability under §6015, which provides for three forms of relief. One of these forms of relief,

§6015(c), provides apportioned relief in respect of a deficiency to taxpayers who are divorced or separated.

Under §6015(c), if the requesting spouse is no longer married to or is legally separated from the spouse with whom she filed the joint return, the requesting spouse (i.e., the one requesting relief) may elect to limit her liability to the portion of a deficiency that is properly allocable to her under §6015(d). In general, §6015(d) provides that any item giving rise to a deficiency on a joint return will be allocated to the spouses as though they had filed separate returns, and the requesting spouse is liable only for her proportionate share of the deficiency that results from such allocation. But §6015(d) does not apply if the requesting spouse had actual knowledge, when signing the return, of an item giving rise to that portion of the deficiency that is otherwise allocable to the nonrequesting spouse. Under Regulation §1.6015-3(c)(2)(i)(A), in the case of omitted income, knowledge of an erroneous item includes knowledge of the receipt of the income, while under Regulation §1.6015-3(c)(2)(i)(B), in the case of an erroneous deduction or credit, knowledge of the item means knowledge of the facts that made the income not allowable as a deduction or credit.

After years in law enforcement in the U.S., Larry Lock, who was college educated, was hired in 2005 by TCI, a private security company and Government contractor, to provide protection in Iraq for U.S. Department of State personnel and other high-ranking U.S. Government officials.

TCI provided Larry with modest living quarters. He lived in a shipping container that had been modified to create two 15-by-15 foot rooms or apartments separated by a single entrance and a shared bathroom. His room included a small refrigerator, a microwave oven, a television, a small desk, and a bed.

Larry enjoyed a support system in Iraq with his "brothers in arms." He primarily associated with fellow Americans working for TCI, but he also befriended others including U.S. Embassy personnel and some Iraqi police and military officers who served as interpreters and assisted TCI personnel as they passed through Iraqi security checkpoints.

Larry felt the stress that came with working in Iraq, and he looked forward to trips to the United States for rest and vacation. He scheduled his vacation time about four or five months in advance and would take as much leave as TCI would allow-usually three to five weeks of leave at a time or a total of about ten weeks yearly.

While Larry was overseas, his wife Kristi and son continued to reside in the couple's marital home in Florida. Kristi completed high school, and was employed as a clerical assistant. She was the primary caregiver for the couple's son while Larry worked overseas. Larry spent most of his TCI vacation time with his family and friends in Florida, and he made an annual trip to Kentucky to spend time with his mother, grandmother, and siblings. During 2010 through 2012, Larry was registered to vote in Florida, maintained a Florida driver's license, and also owned two trucks, a boat, a trailer, and numerous firearms that he stored at his residence in Florida.

From 2010 through 2102, Larry devoted about 200 hours annually to managing rental properties he owned in Florida. In 2011, Larry and a partner organized three Florida limited liability companies, intending to operate a firearms training business and to acquire and operate a franchise specializing in physical fitness training.

Larry's wife moved out of the marital home sometime in mid to late 2012. In October 2012, their marriage was dissolved.

Larry and Kristi attached a Form 2555, Foreign Earned Income, to their joint return for 2010, claimed that Larry was eligible for a foreign earned income exclusion of $91,500, and subtracted that amount from their total income. Their joint return for 2011 reported a foreign earned income exclusion of $92,500. On his tax return for 2012, Larry claimed a foreign earned income exclusion of $95,100. The returns for all three years also claimed large deductions for Larry's unreimbursed employee business expenses. For 2010 and 2011, the Locks claimed large refunds on an overpayment of taxes that were withheld from their salaries; the refunds were transferred by Larry into a money market account he controlled. On his 2012 return, Larry also claimed a large refund on overpayment of tax.

Kristi claimed she qualified for spousal relief under §6015(c) for tax years 2010 and 2011. IRS said she was entitled to such relief but Larry opposed the relief.

The Tax Court held that Larry was not entitled to a foreign earned income exclusion for tax years 2010 through 2012. He had strong family and personal ties in the U.S. throughout the period in question. His wife and the couple's son resided in Florida, and he took them on vacations when he was not working overseas. Although the Locks' marriage apparently was failing, Larry stayed in contact with Kristi while in Iraq, and he relied on her to send him items that he requested. He visited his family in Kentucky at least once a year. Larry also maintained a Florida driver's license and owned trucks, boat, trailer, and firearms that he kept at his Florida home.

Additionally, Larry had numerous economic ties to the U.S., including management of rental and startup businesses. He managed his financial affairs through numerous personal and business bank accounts in Florida. In contrast, his primary, if not sole, tie to Iraq was his work for TCI. Although he spent a considerable amount of time in Iraq, Larry clearly looked forward to leaving Iraq whenever he could to spend time with his family and friends in the U.S. He was permitted to enter Iraq only on visas of fairly limited duration, and he did not pursue any business opportunities, open a banking account, or purchase any property there. The austerity of his living quarters in Iraq was strong evidence that his presence there was transitory and temporary.

In sum, the Tax Court concluded that Larry's abode was within the U.S. for 2010 through 2012, and as a result, he was not eligible for the foreign earned income exclusion under §911. (The Tax Court also denied his claimed deductions for unreimbursed employee business expenses because of lack of proof.)

The Locks accurately reported their gross income on their 2010 and 2011 returns but subtracted from total income significant portions of Larry's income under the claimed foreign earned income exclusion. Under these circumstances, the Tax Court considered the disallowed exclusions to be more akin to a disallowed deduction or credit as opposed to an item of omitted income within the meaning of Regulation §1.6015-3(c)(2)(i)(A). Consequently, the Tax Court evaluated whether his ex-wife had actual knowledge of the facts that led to the disallowance of the exclusions from income (rather than her knowledge of Larry's receipt of the income).

The Tax Court held that the preponderance of the evidence showed that Kristi did not have actual knowledge of the factual circumstances underlying the disallowance of the deductions that Larry claimed for unreimbursed employee expenses or the exclusions that he claimed for foreign earned income for 2010 and 2011. She had a high school education and was not sophisticated in tax matters. Although she signed the tax returns in question for herself and Larry, their tax return preparer did not review the returns with her. Nor was there evidence that Larry discussed with Kristi the facts underlying the items in dispute or that she intentionally avoided learning about them.

In the light of all the circumstances, the Tax Court concluded that Kristi qualified for spousal relief under §6015(c). Although IRS issued tax refunds for tax years 2010 and 2011, the record showed that those refunds were electronically deposited to Larry's account, and he transferred substantial portions of those refunds to other accounts that he controlled. Since the record did not reflect that

Kristi received a tax benefit on the couple's joint returns, the Tax Court concluded that there was no reason to allocate any portion of the deficiencies to her.

Long, TC Summary Opinion 2016-88.

In a Summary Opinion, the Tax Court has determined that a taxpayer could deduct the costs of obtaining a master of business administration (MBA) as unreimbursed employee expenses. The Court found that the MBA did not qualify him for a new profession but rather refined his existing business and investment skills that he used in his former managerial position, and it further concluded that the taxpayer remained in the same trade or business before and after attaining the degree.

Education expenses are deductible under §162(a) if made by a taxpayer either to maintain or improve skills required in his business or employment or to meet the express requirements of his employer, or the requirements of law or regulations, imposed as a condition to retaining his salary, status or employment. (Regulation §1.162-5)

Generally, the performance of services as an employee constitutes a trade or business. (Primuth, (1970) 54 TC 374) A taxpayer may deduct unreimbursed employee expenses incurred only as miscellaneous itemized deductions on Schedule A, Itemized Deductions, and then only to the extent such expenses exceed 2% of the individual's adjusted gross income. (§62(a)(2), §63(a), §63(d), §67(a), §67(b), §162(a))

However, deductions are not allowed if the education:

a. Is needed to meet the minimum requirements for taxpayer's present or intended employment, trade, business or profession (Regulation §1.162-5(b)(2)) or

b. Is undertaken to fulfill general education aspirations or for other personal reasons, or

c. Is part of a program of study that will lead to qualifying the individual in a new trade or business. (Regulation §1.162-5(b)(3)(i))

Tao Long began working at Broadcom Corporation in 2005. He started as a design engineer and, after a series of promotions, was a product line manager. His responsibilities included market, product, and trend analysis, creating proposals about products for upper management that included financial analysis, and managing teams that developed and introduced products to the market. He also evaluated potential mergers and acquisitions, focusing on financial analysis and time-to-market assessment.

Apart from his work at Broadcom, starting in 2006 and continuing through the years at issue (2010 and 2011), Long was a general partner of an investment club and was responsible for managing the funds.

Long passed levels I, II, and III of the Chartered Financial Analyst (CFA) Institute exam in December 2007, June 2008, and June 2009. He also passed levels I and II of the Chartered Alternative Investment Analyst (CAIA) Association exam in September 2009 and March 2010. He was awarded his CFA charter, and received the CAIA designation and became a CAIA member, in 2012.

Long enrolled in the MBA program at the Wharton School, University of Pennsylvania in May 2010. His coursework was finance and management-related; he took courses such as financial accounting, new product management, and corporate valuation. Broadcom had an educational assistance policy at the time, but Long did not seek or receive reimbursement.

Long resigned from his position at Broadcom in May 2011 immediately before starting a full-time summer internship at an investment bank, from June through August 2011. He did not work again until January 2012 when he began working at Connective Capital Management, LLC (Connective Capital) as a senior research analyst. The job posting stated that the senior research analyst would "lead research activities in technology and industrial sectors, with responsibility for all aspects including idea generation, technology/product review, business model and competitive analysis, primary research utilizing Connective's industry network, valuation modeling, and risk management." The job listing also stated a preference for candidates with MBAs from top universities.

Long graduated from Wharton and received his MBA in April 2012.

On his 2010 and 2011 Federal income tax returns, Long reported salary income of $527,860 and $117,888, respectively. He also filed Schedule Cs for a purported real estate activity (which the Court found was not engaged in for profit) and claimed deductions for, among other things, tuition and related expenses for attending the MBA program.

The Court found that, while Long could not deduct his education costs in connection with his real estate activity as he originally claimed, he could deduct them as unreimbursed employee expenses.

While IRS conceded that the degree was not incurred to meet the minimum educational requirements of Long's trade or business, it asserted that the expenses were nondeductible because Long's MBA qualified him for a new trade or business. IRS argued that the MBA enabled him to acquire the senior research analyst position with Connective Capital, noting that the job posting stated a preference for MBA holders.

The Court, however, rejected this argument and found that Long was in the same trade or business before enrolling in the MBA program and remained in that trade or business when he took on the new position at Connective Capital. He was qualified in financial analysis through his studies and personal investment experience before enrolling in the MBA program in May 2010, as demonstrated by his passing the CAIA and CFA exams before enrolling, and he was also developing financial skills as general partner of the investment partnership. IRS also emphasized that Long did not become a CFA charter holder or a CAIA member until 2012, but the Court accepted Long's explanation that the annual fees were costly and just passing the exams was sufficient to demonstrate knowledge and expertise.

The Tax Court also noted that a taxpayer may be engaged in a trade or business, although not currently working, if he was previously involved in and actively sought to continue in that trade or business while pursuing a defined degree program related to his or her line of work. (Ford, (1971) 56 TC 1300) Long was not working for an employer from September through December 2011, but the Court found that the facts clearly showed that he intended to find another position and continue his professional career.

The Court then considered whether Long's potential entitlement to reimbursement precluded his deduction and found that it did not. Although Long met many of the requirements for Broadcom's educational assistance policy, his decision to not seek reimbursement was reasonable because he left the company less than a year later and would have had to re-pay any amounts that he was reimbursed.

Accordingly, Long was entitled to deduct the costs of the MBA program as unreimbursed employee expenses, subject to any applicable limitations.

Lopez, TC Summary Opinion 2017-16.

The Tax Court, rejecting IRS's full disallowance of a taxpayer's claimed Schedule C gross receipts and corresponding reduction or disallowance of the earned income tax credit(EITC) and additional child tax credit, has held that a taxpayer was engaged in a cosmetology business and received some income from it. However, taking into account the overall facts of the case, including the taxpayer's failure to maintain adequate records, the Court concluded that she received gross receipts in a lesser amount that she reported, and the amount of EITC and additional child tax credit that she claimed were accordingly reduced.

Under §32(a)(1), an eligible individual is allowed a refundable earned income tax credit(EITC) against his or her income tax, computed by multiplying the taxpayer's allowable earned income by a credit percentage. (§32(a)(1)) The term "earned income" includes wages and net earnings from self-employment. (§32(c)(2)(A)) A taxpayer claiming the credit must establish that he or she had earned income and the amount of that income. A taxpayer who erroneously claims the earned income credit(EIC) due to recklessness or intentional disregard of rules or regulations is ineligible to claim the EIC for a later period of two years. (§32(k)(1)(B)(ii))

§24(a) provides that a taxpayer is allowed a credit against his or her income tax for the tax year with respect to each qualifying child of the taxpayer for which the taxpayer is allowed a dependency exemption deduction under §151. The child tax credit is partially refundable, with the refundable portion referred to as the "additional child tax credit."

Rita Lopez lived with her two minor daughters in a rented 3-bedroom apartment in New York. During 2012 and 2013(the years at issue), she was a self-employed cosmetologist specializing in hairstyling. She operated her unlicensed business from her residence and met with at least 12 of her customers regularly, charging anywhere from $10 to $50 per appointment. Most of her customers consisted of her neighbors and friends.

Lopez did not maintain a bank account during the years in issue, nor did she maintain any contemporaneous business records showing the income and expenses attributable to her business. She asserted that her customers paid her in cash, and she did not provide receipts for those payments. In addition to her cosmetology business income, Lopez received $2,000 of nonemployee compensation related to referral fees from a car dealership in 2013, which she failed to report that year.

Lopez had her returns prepared by a paid income tax preparer for both years and filed on time. On her 2012 return, she claimed head of household filing status, and on her 2013 return, she claimed single filing status. For both years, Lopez claimed two dependency exemption deductions, an EITC, and an additional child tax credit. Each return included a Schedule C, Profit or Loss From Business, relating to her cosmetology business, reporting gross income of $17,800 for 2012 and $17,581 for 2013. She also reported $2,015 in cosmetology-related expenses for 2012, resulting in a net profit of $15,785 for that year, and no expenses in 2013.

IRS issued a deficiency notice adjusting her income each year by eliminating the Schedule C gross receipts, then disallowing or decreasing the amounts of the above-referenced credits that she claimed. This resulted in deficiencies of $5,048 and $4,888, respectively. IRS further determined that, under §32(k)(1)(B)(ii), Lopez was barred from claiming an EITC for certain future years.

The Tax Court found that, despite the lack of business records, Lopez was engaged in the cosmetology business during the years in issue as she claimed. Notarized written statements from her clients, each dated in March 2015 and provided to IRS during its examination of her 2012 and 2013 returns, corroborated her testimony that she was paid to provide cosmetology services to at least 12 regular customers. While the Court "appreciated" IRS's "suspicions in situations seemingly designed to maximize the refundable credits," it found that IRS failed to introduce any direct evidence with respect to Lopez casting doubt on her claim to have been in the cosmetology business.

However, in the absence of written records showing how Lopez computed the amount of gross income on each Schedule C, and noting questions about the legitimacy of some of the written statements provided in support of her claims, the Court found that Lopez had gross receipts from her cosmetology business totaling $10,000 each year, noting that "[a]ny inexactitude inherent in our finding is attributable to petitioner's lack of contemporaneous records." Accordingly, Lopez was still entitled for each year to an EITC and additional child tax credit, but in reduced amounts. And, in light of the fact that the EITC would not be entirely disallowed for either year, the Court "made no comment...regarding the application" of §32(k) but noted that the failure to maintain adequate records to support items shown on a return could support a finding of negligence for purposes of the accuracy-related penalty under §6662(a).

Maciujec, TC Summary Opinion 2017-49.

Former employee of Home Depot could not exclude under §104(a)(2) an amount she received from the company to settle a suit alleging discrimination and other actions that she said caused emotional distress. She did not receive damages for emotional distress attributable to a physical injury or sickness and thus the settlement payment was not excludable.

§104(a)(2) excludes from gross income damages taxpayers receive for personal physical injury or physical sickness. Because emotional distress is not considered a physical injury or physical sickness, taxpayers must include damages they receive for emotional distress in their gross income unless the damages are paid for medical care attributable to the emotional distress. (§104(a)) But damages for emotional distress attributable to a physical injury or physical sickness are excluded from income under §104(a)(2). (Regulation §1.104-1(c))

When a taxpayer receives a payment under a settlement agreement, the nature of the claim that was the actual basis for settlement determines whether such payments are excludable from income.

After Home Depot terminated Liudmela Maciujec's employment in February 2010, her attorney filed a civil complaint for damages against Home Depot. The complaint identified 10 causes of action and alleged that, in the course of her employment at Home Depot, Maciujec was subjected to various forms of discrimination, harassment, and retaliation, that the company failed to accommodate her physical disability (an inability to stand for extended periods), that a coworker had committed a battery on her (unwanted touching and offensive physical contact), and that she was wrongfully terminated. Each of the 10 causes of action included an allegation that the conduct of Home Depot and its employees caused Maciujec to suffer emotional distress. The complaint did not allege that Maciujec suffered any physical injury or sickness as a result of the conduct of Home Depot or its employees.

The complaint requested general damages, an award for loss of earning, costs of the lawsuit, attorney's fees, and punitive damages. On May 16, 2013, Maciujec and Home Depot entered into a settlement agreement and general release (settlement agreement). The settlement agreement said Home Depot agreed to pay $72,000 to Maciujec, as payment for her claims of compensatory damages (including emotional distress). The agreement specifically stated that Maciujec did not seek medical treatment or incur medical costs as a result of the claims asserted in her lawsuit. No portion of the settlement payment was allocated to any particular cause of action in the complaint.

Home Depot issued to Maciujec a Form 1099-MISC, Miscellaneous Income, reporting that she had received taxable income of $104,500 in 2013 as a result of the settlement of the lawsuit. Maciujec gave her CPA copies of the Home Depot complaint and the settlement agreement, and she specifically inquired whether he believed that the settlement payment constituted taxable income. The CPA filed a 2013 income tax return for Maciujec that did not report as gross or taxable income the miscellaneous income that Home Depot had reported on Form 1099-MISC. Instead, the CPA included with Maciujec's tax return (1) a schedule indicating that she had received other income of $104,500 from Home Depot and (2) a separate statement that she had sustained "sexual abuse injuries" at Home Depot, and, therefore, she considered the settlement payment to be nontaxable under §104(a).

IRS said $72,000 of the settlement payment was not excludable (Maciujec did not have to include in income $32,500 paid directly to her attorney) and determined that she owed $23,396 in tax for 2013, plus an accuracy-related penalty under §6662(a).

The Tax Court determined that the settlement payment was taxable income to Maciujec. The complaint that Maciujec filed against Home Depot did not include an allegation that she suffered any physical injury or physical sickness as a result of the conduct of Home Depot or its employees. The complaint states that she suffered "loss of income, wages and other pecuniary losses" and "mental anguish, embarrassment, humiliation, and emotional distress." Although Maciujec may have suffered physically as a result of the battery described in the complaint, there was no indication in the settlement agreement or in the record as a whole that she was compensated for a physical injury or physical sickness, or emotional distress attributable thereto. What's more, Maciujec did not claim that any portion of the settlement payment served to reimburse her for amounts paid for medical care attributable to emotional distress.

In sum, the Tax Court concluded that Maciujec did not receive damages for emotional distress that were attributable to a physical injury or physical sickness and, accordingly, the $72,000 settlement payment to her was not excludable under §104(a)(2).

But the Tax Court said Maciujec did not owe the §6662 accuracy-related penalty, which does not apply to any portion of the underpayment for which the taxpayer shows that there was reasonable cause and that he or she acted in good faith. (§6664(c)(1)) Maciujec established good-faith reliance on her professional tax adviser since she gave him complete and accurate information, filed an incorrect return as a result of his mistake, and believed in good faith that she was relying on a competent adviser's advice. Considering all the facts and circumstances, including Maciujec's lack of sophistication regarding tax matters, the Tax Court concluded that Maciujec showed reasonable cause for the entire underpayment and that she acted in good faith in relying on her CPA's advice.

Makhlouf, TC Summary Opinion 2017-1.

Taxpayers were not real estate professionals for purposes of the passive activity loss (PAL) rules. They failed to show that they performed more than 750 hours of services during the tax year in real property trades or businesses in which they materially participated.

Under §469(c)(1), the PAL disallowance rules apply to any trade or business in which the taxpayer does not materially participate. In general, any rental activity is per se a passive activity regardless of the taxpayer's participation in the activity. (§469(c)(2)) However, there are exceptions to the per se rule for: (a) real estate professionals; and (b) up to $25,000 of losses, subject to an adjusted gross income (AGI) phaseout.

Under §469(c)(7), the per se rule for rental activities does not apply to a qualifying real estate professional. A taxpayer qualifies as such for a particular tax year if: (1) more than half of the personal services that he performs during that year are performed in real property trades or businesses in which he materially participates; and (2) he performs more than 750 hours of services during that tax year in real property trades or businesses in which he materially participates. For taxpayers filing a joint return, either spouse may separately satisfy the real estate professional requirements.

An individual who: (a) has at least a 10% interest in any rental real estate activity, and (b) otherwise actively participates in that activity, may offset up to $25,000 of nonpassive income with that portion of the passive activity loss, or of the deduction equivalent of the passive activity credit, attributable to that activity. The $25,000 allowance ($12,500 for marrieds filing separately) is reduced (but not below zero) by 50% of the amount by which the taxpayer's adjusted gross income (AGI) as specially computed exceeds (i) $100,000 ($50,000 for marrieds filing separately), or (ii) $200,000 ($100,000 for marrieds filing separately) for any portion of the passive activity credit that is attributable to the rehabilitation credit. (§469(i))

Mahmoud and Jane Makhlouf owned the following rental properties during the year at issue (2010): their former residence in Weston, Massachusetts (the Weston property) and an interest in two apartment buildings in Cairo, Egypt (the Dokki property). The remaining interests in the Dokki property were owned by family members. Although they were retired during 2010, they stated that they engaged in extensive management activities with respect to the Weston and the Dokki properties.

The activities relating to the Weston property consisted primarily of arranging for and supervising contractors dealing with such items as handling insect infestation, plumbing problems with the sprinkler system, and the replacement of a dishwasher.

The activities relating to the Dokki property consisted primarily of meetings with family members during two trips to Egypt and included discussing legal, business, and investment matters concerning the family's real estate holdings generally. The taxpayers also stated that they devoted additional hours to the Dokki property while back at home by reading documents and sending emails.

To substantiate the hours devoted to the rental real estate activity, the taxpayers prepared and provided IRS with two documents: a Weston spreadsheet and a Dokki spreadsheet. Both documents were created after 2010, allegedly on the basis of computer entries and a diary that Mrs. Makhlouf kept. The diary of their trips to Egypt showed substantial amounts of time devoted to personal activities, including touring the pyramids and visiting Luxor.

The taxpayers included a Schedule E (Supplemental Income and Loss) on their 2010 return in which they reported: (a) rental income of $74,850 and total expenses of $149,036 for the Weston property, for a net loss of $74,186; and (b) rental income of $8,000 and expenses of $4,000 for the Dokki property, for a net profit of $4,000.

On audit, IRS concluded that the Makhloufs had actively participated in a rental real estate activity, but only allowed a deduction for $15,106 of their reported Schedule E loss under §469(i). (IRS found that their AGI for 2010 was $119,789 so that their loss deduction was partially phased out.). IRS disallowed the balance of the loss deduction as a nondeductible passive loss on the ground that the Makhloufs were not engaged in a real property business under §469(c)(7).

The Tax Court determined that the taxpayers were not real estate professionals during 2010 because the 200 hours of material participation by the taxpayers that the Court found was attributable to the Weston property, when added to the 100 hours of material participation by the taxpayers that the Court found was attributable to the Dokki property, came well short of the 750 hours required. Accordingly, the Court sustained IRS's disallowance of their $55,080 rental real estate loss deduction.

With regard to the Weston property, the Tax Court found that the hours shown on the Weston spreadsheet were inflated, duplicative, and implausible on their face. Few if any entries were supported by contemporaneous record keeping. The Court speculated that if any probative value were attached to this document, it would find that the Makhloufs together spent at most 200 hours on tasks relating to management of the Weston property.

The Tax Court did not find credible Mrs. Makhlouf's testimony that the Weston spreadsheet was created using information that she had maintained contemporaneously in a diary and that these data were later entered into a computer program. Her diary contained very few entries apart from noting days on which they traveled between the Weston property and their residence. Her diary did not show the start and end times for particular tasks or the total numbers of hours worked on any day.

The Weston spreadsheet, which the Court noted was not prepared contemporaneously, was implausible on its face in many respects. It showed that the taxpayers allegedly spent 102 hours reading or writing emails relating to the Weston property, for a total of 204 hours, with each such exercise supposedly lasted 30 minutes. The taxpayers allegedly paid bills on 26 separate occasions, and each bill paying exercise supposedly lasted at least one hour and often longer, for a total of 64 hours paying bills for a single rental property. The taxpayers allegedly devoted 105 hours during October through December 2010 to "work on taxes for 2010," but offered no credible explanation why they would have devoted 105 hours to such tasks before the 2010 tax year ended.

In addition, for most entries on the spreadsheet, each of the Makhloufs supposedly devoted the exact same number of hours to the task in question-whether reading tax instructions and filling forms, meeting with contractors, or supervising yard work. For example, each of the Makhloufs allegedly spent 36 hours, for a total of 72 hours, meeting with an insurance agent about a change to their homeowner’s insurance policy.

With regard to the Dokki property, the Tax Court found that the Dokki spreadsheet, which the Court noted was not prepared contemporaneously, also lacked plausibility. The hours listed for family meetings were clearly inflated: numerous entries report improbable all-day meetings, and some of the entries were contradicted by entries in Mrs. Makhlouf's diary. The Court speculated that if any probative value were attached to this document, it would find that the taxpayers together spent at most 100 hours on tasks relating to management of the Dokki property.

The taxpayers spent 73 days in Egypt during 2010. Ignoring the 88 hours of travel time, the spreadsheet reported that the Mr. and Mrs. Makhlouf devoted 309 hours and 209 hours, respectively, to the Dokki property. But the evidence did not show the extent to which Mr. Makhlouf's meetings with family members concerned his specific investment in the Dokki property, as opposed to general business and investment matters. The Tax Court did not believe that he devoted on average more than four hours each day, seven days a week, to a real estate property that yielded him only $8,000 in rental income, while also visiting family, touring the pyramids and Luxor, and otherwise enjoying a vacation. And the Court did not believe that Mrs. Makhlouf spent 210 hours attending business meetings with her husband's family when she had no apparent interest in that business.

Martin, (2017) 149 TC No. 12

The Tax Court, reversing its holding in previous similar cases and following the reasoning of the Court of Appeals for the Eighth Circuit, has held that where a corporation paid its sole shareholders both rent for farmland and wages for work the shareholders performed on the farmland, the rent was not subject to self-employment tax. A dissenting opinion held that the majority misinterpreted the holding of the Eighth Circuit.

A taxpayer's self-employment income is subject to self-employment tax. (§1401(a) , §1401(b)) Self-employment income is generally defined by §1402(b) as the net earnings from self-employment derived by an individual.

In general, §1402(a) defines net earnings from self-employment as the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by subtitle A which are attributable to such trade or business, plus his or her distributive share (whether or not distributed) of income or loss described in §702(a)(8) from any trade or business carried on by a partnership of which he or she is a member. An enumerated list of specific rules (i.e., primarily exclusions) apply in computing net earnings from self-employment.

§1402(a)(1) provides that net earnings from self-employment generally don't include rentals from real estate and related deductions. However, a lessor (either the owner or a tenant-lessor) has self-employment income if: (A) the income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual must produce agricultural or horticultural commodities on such land and that there must be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or management of the production of such agricultural or horticultural commodities, and (B) there actually is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity. (§1402(a)(1))

The taxpayers, Mr. and Mrs. Martin, owned 300 acres of agricultural land. They entered an arrangement with a large poultry producer, Sanderson Farms, to raise chickens for Sanderson. Sanderson owned the chickens and provided the feed and had very specific requirements that the Martins had to meet under their contract with Sanderson. The Martins had to install specialized equipment at a cost of more than $1.2 million.

In carrying out Sanderson Farms' detailed instructions, the Martins were allowed to hire laborers.
During the term of their contract with Sanderson Farms, the Martins organized an S corporation, CL Farms, of which they were the sole shareholders. Sanderson Farms approved of the Martins' assignment of the remainder of their contract with Sanderson Farms to CL Farms.

When they incorporated CL Farms, the Martins had their farm and all of its structures and equipment appraised. Using the appraisal as a guide for the cost of labor and management services and incorporating information gathered from other broiler growers, the Martins entered into oral employee agreements with CL Farms and set their salaries and those of the other farm workers at amounts consistent with those of other growers.

CL Farms leased the farmland and equipment from the Martins. In its 5-year lease, CL Farms agreed to pay rent of $1.3 million to the Martins. The agreement required CL Farms to remit each rent payment irrespective of whether it had fulfilled its requirements as grower to Sanderson Farms or received sufficient income. This amount represented fair market rent and was consistent with amounts paid by other Sanderson Farms growers for the use of similar premises.

The only issue in the case was whether, under §1402(a)(1) , the rental income CL Farms paid the Martins was subject to self-employment tax.

The Court held that the rental income was not subject to self-employment tax.

In previous cases with similar facts, e.g. *McNamara, TC Memo 1999-333 (McNamara I),* the Tax Court had come to the opposite conclusion. But, the Eighth Circuit, in *McNamara, (CA 8 2000) 87 AFTR 2d 2001-310* (McNamara II), reversed McNamara I. It said that the mere existence of an arrangement requiring and resulting in material participation in agricultural production does not automatically transform rents received by the landowner into self-employment income. It is only where the payment of those rents comprises part of such arrangement that such rents can be said to derive from the arrangement. Rents that are consistent with market rates very strongly suggest that the rental arrangement stands on its own as an independent transaction and cannot be said to be part of an "arrangement" for participation in agricultural production.

The Court here adopted the reasoning from McNamara II. It said that, regardless of a taxpayer's material participation, if the rental income is shown to be less than or equal to market value for rent, the income is presumed to be unrelated to any employment agreement. At that point, the burden of production shifts to IRS to show a nexus between the rent and the taxpayer's obligation to materially participate. Such a showing would render the lease and employment agreements part and parcel of a larger "arrangement." Here, the rent was less than or equal to market value rent. And, IRS did not brief the issue of the nexus between the rent and the obligation to materially participate.

A dissenting opinion disagreed with the majority's holding that IRS had the burden of production once the taxpayer established that the rent was reasonable. It said that nothing in McNamara II supported the majority's arriving at that conclusion.

Victoria Malev v. Commissioner, Docket No. 1282-16S.

In an oral finding of fact and opinion (Bench Opinion), the Tax Court has concluded in a small tax case under §7463 that a taxpayer could deduct her expenses for integrative medical care as a medical expense under §213.

Observation: In a Bench Opinion in a regular or small tax case, the Tax Court Judge orally states the opinion in court during the trial session. The Tax Court will then send the parties a copy of the transcript reflecting the Judge's opinion within a few weeks after the trial. In addition, all bench opinions delivered after March 1, 2008, are electronically viewable through the Tax Court's Docket Inquiry system. A Bench Opinion cannot be relied on as precedent.

§213(a) allows a deduction for expenses paid during the tax year for medical care of the taxpayer, spouse or dependent. An expense is considered for medical care if it is paid for the diagnosis, cure, mitigation, treatment or prevention of disease or for the purpose of affecting any structure or function of the body. (§213(d)(1)(A)) For tax years beginning after December 31, 2016, the amount of medical expenses an individual may deduct in a tax year is the amount by which her unreimbursed payments for those expenses exceed 10% of her adjusted gross income (AGI) for the year.

Observation: Medical expenses for all taxpayers that itemized were deductible to the extent they cumulatively exceeded 7.5% of AGI. However, in 2010, the Affordable Care Act (ACA) raised this floor. For tax years beginning after December 31, 2012, the floor for medical expenses was increased from 7.5% of AGI to 10% of AGI. (§213(a), as amended by Health Care Act §9013(a)) However, for tax years beginning after December 31, 2012 and ending before January 1, 2017 (i.e., for 2013, 2014, 2015, and 2016) the 7.5% floor remained 7.5% if the taxpayer or his or her spouse has reached age 65 before the close of the tax year. (§213(f)) Legislative proposals to repeal and replace the ACA often include a provision that would restore the 7.5% floor.

Expenses incurred which are merely beneficial to the general health of an individual are not deductible. (Regulation §1.213-1(e)(1)(ii))

Regulation §1.213-1(e)(1)(ii) provides that amounts paid for operations or treatments affecting any portion of the body, including obstetrical expenses and expenses of therapy or X-ray treatments, are considered to be for the purposes of affecting a structure or function of the body and are therefore paid for medical care. "Thus, payments for the following are payments for medical care: hospital services, nursing services (including nurse's board where paid by the taxpayer), medical, laboratory, surgical, dental and other diagnostic and healing services [italics added], X-rays, medicine and drugs."

The Tax Court allowed a medical expense deduction to a taxpayer suffering from a recurrence of breast cancer for the cost of consultations with, and dietary supplements prescribed by, a "naturopathic doctor" (i.e., a practitioner of naturopathy, defined as a system of treatment of a disease emphasizing assistance to nature and sometimes including the use of natural medical substances such as herbs, vitamins, and salts, and certain physical means, such as manipulation and electrical treatment). The practitioner of naturopathy was not a medical doctor. (*Dickie,* TC Memo 1999-138)

While noting that holistic healing costs could qualify as medical expenses, the Tax Court denied a medical expense deduction because the taxpayer who incurred expenses for a holistic healing center in treatment of her cancer, had died, and her surviving spouse was unable to specify the type of care received, other than to say that it involved dietary approaches and did not involve traditional cancer treatments. (*Crain,* TC Memo 1986-138)

The Tax Court determined the amount of a Navajo Indian's deduction for cost of "sings" performed by a medicine man where IRS did not contend that the traditional Navajo medical treatment performed by Navajo medicine men was not medical care within the meaning of §213(e)(1), but challenged the taxpayer's expenditures for failure to substantiate them. (*Tso*, TC Memo 1980-399)

Victoria Malev suffers from at least one spinal disease. She apparently received only partial and temporary relief from the pain associated with the disease through chiropractic treatment. In a diagnosis dated November 25, 2016, which was after the year in issue, her medical doctor suggested surgery as a remedy, but advised her that the surgery "does not come with complete success, and carries the possibility of worsening" her condition. Her medical doctor further "recommended" "integrative medical care."

As the Tax Court noted, according to Duke University, "Integrative medicine is an approach to care that puts the patient at the center and addresses the full range of physical, emotional, mental, social, spiritual and environmental influences that affect a person's health. Employing a personalized strategy that considers the patient's unique conditions, needs and circumstances, it uses the most appropriate interventions from an array of scientific disciplines to heal illness and disease and help people regain and maintain optimum health."

Observation: Integrative medicine may include such practices as herbal medicine, nutrition counseling, acupuncture, massage, biofeedback, yoga, tai chi, meditation, and other stress reduction programs.

During 2012, Ms. Malev paid expenses for integrative medical care, which was not compensated by insurance or other means. On her return, she deducted these expenses. On audit, IRS challenged that deduction.

While noting that it fully appreciated IRS's position and considered that its position was more than justified, the Tax Court found that the taxpayer was entitled to the medical expense deduction she claimed on her 2012 return.

The Court noted that had the November 25, 2016, diagnosis been given before 2012, this would have been an easy case. That diagnosis included a recommendation that Ms. Malev pursue integrated medical treatment, and that recommendation having been made by a recognized medical professional would probably in and of itself support a deduction for expenses paid to seek such care. But the Tax Court pointed out, the diagnosis came later, and, the Court said the diagnosis "seems to speak in the time frame in which it was made," (i.e., 2016) which would undermine, at least to some extent, the taxpayer's claim to have been cured by the treatments she received several years earlier in 2012.

In reaching its pro-taxpayer conclusion, the Tax Court considered:

1. The literal language of §213 and its underlying regulations, which speak in broad terms. The Court noted the word "heal" in the definition of integrative medicine was critical, as Regulation §1.213-1(e)(1)(ii) provides that an expense paid by a taxpayer for "healing services" directed towards any structure of the body may be deducted as a medical expense;

2. Ms. Malev's sincere belief that the expenses she paid for the treatments she received were directed to cure or mitigate the symptoms of her spinal disease. The Court said it was more persuaded by her belief as to the effectiveness of the treatments she paid for than it was by its own impression as to those treatments. At trial, Ms. Malev testified that her condition had greatly improved as a result of the treatments;

3. The expenses incurred by Ms. Malev for the treatments she received were not of the type that an individual would routinely incur for non-medical reasons;

4. Nothing in the record suggested that the relationship between Ms. Malev and any of the four individuals whom she paid for the services was other than professional; and

5. The Tax Court's own recognition that expenses paid for "alternative medical" treatments can be deducted as a medical expense under §213. (See *Dickie, Crain, and Tso*)

The Court reasoned that, concerned that conventional treatments for her condition posed too much risk or were or would be ineffective, the taxpayer subscribed to various forms of treatment from four individuals, none of whom would be commonly recognized as a conventional medical caregiver. The Court noted that "to be sure, none of the methods utilized by these individuals would commonly be recognized as a conventional medical treatment." Further, the Court opined, "The methods the taxpayer subscribed to might be termed "alternative medicine" by the polite, but we expect the less tolerant would characterize the treatments in other than legitimate or complimentary terms."

In its analysis, the Tax Court focused not only on what §213 and its regulations require to support a medical expense deduction, but also on what is not required as well. Nothing in the statute or the underlying regulations requires that the treatments received by a taxpayer be furnished by an individual licensed to practice medicine in any particular discipline, or that the treatment be successful, or that the treatment be universally accepted as effective.

In reaching a decision under the circumstances of this case, the Tax Court found that it was faced with a difficult task. The Court concluded that, "Our resolution must take into account not only what is known but what is less understood as well; namely, the role that an individual's state of mind plays in the treatment of the individual's disease."

Malone, (2017) 148 TC No. 16.

Where a partner omits a partnership item from his individual tax return, and the partnership itself was subject to a TEFRA audit, the Court has jurisdiction to determine that partner's resulting negligence penalty.

The Tax Court's jurisdiction generally is limited to the review of deficiencies asserted by IRS (and not paid when the 90-day letter is issued). (§6512(a))

The following rules apply to TEFRA (i.e., the Tax Equity and Fiscal Responsibility Act of 1982) unified audit and litigation procedures. These procedures generally apply to partnership tax years that begin before January 1, 2018.

Whether a tax item of a partnership or a partner is a "partnership item" or a "nonpartnership item" governs whether it is addressed in partnership-level proceedings or partner-level proceedings. A partnership item is "any item required to be taken into account for the partnership's tax year under any provision of subtitle A to the extent [the] regulations...provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level." (§6231(a)(3)) Nonpartnership items are defined in the negative to be "an item which is (or is treated as) not a partnership item." (§6231(a)(4))

Some nonpartnership items, even though they might have nothing to do with a partnership item, are affected items. The Code defines affected items to be "any item to the extent such item is affected by a partnership item." (§6231(a)(5)) An example might be an individual's Schedule A deduction for medical expenses. Medical expense deductions are subject to a floor. (§213(a)) If the income flowing to a partner changes, then the floor for medical expense deductions changes.

Affected items are further divided into two subcategories: computational affected items and factual affected items. A computational affected item is one that can be determined mathematically, such as the medical expense deduction just described. (§6231(a)(6)) A factual affected item is an affected item that requires further factual determinations at the partner level. (*Hambrose Leasing 1984-5 Ltd. Partnership,* (1992) 99 TC 298)

Whether an affected item is factual or computational generally determines what procedures apply to the assessment of tax relating to that item. Computational affected items are not subject to deficiency procedures. (§6230(a)(1)) Following a TEFRA proceeding, IRS may assess tax attributable to those items, along with the tax attributable to partnership items, by way of computational adjustment. (§6231(a)(6)) In contrast, affected items that require partner-level factual determinations are subject to deficiency procedures. (§6230(a)(2)(A)(i))

Penalties that are factual affected items, however, require one further step of analysis to determine whether deficiency procedures apply. §6221 provides that "the tax treatment of any partnership item (and the applicability of any penalty...which relates to an adjustment to a partnership item) shall be determined at the partnership level." Likewise, §6230(a)(2)(A)(i) excludes from deficiency procedures "penalties...that relate to adjustments to partnership items" irrespective of their status as affected items.

The taxpayers were Mr. and Mrs. Malone who filed a joint return. Mr. Malone was a partner in MBJ, a partnership. The partnership reported gain from installment sales of partnership assets. The Malones did not report the gain on their joint return and did not file a Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request, or otherwise notify IRS that they were taking a position inconsistent with that reported by MBJ. IRS issued a notice of deficiency with respect to the unpaid taxes and the penalty for negligence.

The only issue before the Court was whether it had jurisdiction to determine the applicability of the negligence penalty. More specifically, the Court considered whether the deficiency procedures apply to a §6662(a) accuracy-related penalty for negligence imposed solely because of a partner's inconsistent reporting of partnership items.

The Court held that, because there were no adjustments to partnership items, deficiency procedures applied to the penalty.

The Court began "with an easy proposition" that §6662(a) penalties, such as the one asserted here, are found in subtitle F of title 26-not in subtitle A. Because partnership items are limited to items arising under subtitle A, this penalty is not a partnership item; it is a nonpartnership item. Thus, unless it is a computational affected item, it is subject to deficiency proceedings.

The Court then said that, synthesizing much of the law discussed above, deficiency procedures generally do not apply to the assessment of tax that may be determined computationally and included in a computational adjustment. (§6230(a)(1)) However, deficiency procedures continue to apply to the assessment of tax attributable to affected items that require partner-level determinations. But, Congress excluded from deficiency proceedings "penalties, additions to tax, and additional amounts that relate to adjustments to partnership items."

In this case, there were no adjustments to partnership items. There was no dispute that the partnership items reported by MBJ were not adjusted-IRS did not attempt to dispute the items as reported on MBJ's Form 1065.

The Malones argued, however, that the inconsistently reported partnership items on their Form 1040 were "adjusted" within the meaning of §6230(a)(2)(A)(i). The Court disagreed. The adjustments made to the liability reported on the Malones' Form 1040 were computational adjustments to their tax liability to take into account the partnership items as originally reported by MBJ. There were no adjustments to partnership items. Accordingly, the §6230(a)(2)(A)(i) exclusion from deficiency procedures was inapplicable to the negligence penalty before the Court in this case. Therefore, deficiency procedures applied, and the Court had jurisdiction.

Estate of Andrew McKelvey, (2017) 148 TC No. 13.

Modifications made to a taxpayer's variable prepaid forward contracts (VPFCs) did not result in taxable exchanges under §1001 and so the VPFC transaction remained open until closed by the future delivery of stock.

A standard forward contract is an executory contract in which a forward buyer agrees to purchase from a forward seller a fixed quantity of property at a fixed price, with both payment and delivery occurring on a specified future date. The VPFC is a variation of a standard forward contract, requiring the forward buyer (usually a bank) to pay forward price (discounted to present value) to the forward seller on the date of contract execution, rather than on the date of contract maturity. A forward seller can use the upfront cash prepayment however he or she deems fit; often, the proceeds are used by the forward seller to diversify a concentrated stock position into other securities or financial instruments. In exchange for the cash prepayment, the forward seller becomes obligated to deliver to the forward buyer: (1) shares of stock that have been pledged as collateral at the inception of the contract; (2) identical shares of the stock which have not been pledged as collateral; or (3) an equivalent cash amount. The actual number of shares (or cash equivalent) to be delivered by the forward seller is determined by a formula which takes into account changes in the market price of the underlying stock over the duration of the contract. (See *Anschutz Co. v. Commissioner,* (2010) 135 TC 78, aff'd, (CA 10 2011), 108 AFTR 2d 2011-7590.)

As a general rule, the entire amount of gain or loss on a sale or exchange of property must be recognized under §1001(c).

Under §1259(a)(1), if there is a constructive sale of an appreciated financial position, the taxpayer must recognize gain as if the position were sold, assigned, or otherwise terminated at its fair market value (FMV) on the date of the constructive sale. Under §1259(c)(1)(C), a taxpayer is treated as having made a constructive sale of an appreciated financial position if he (or a related person) enters into a futures or forward contract to deliver the same or substantially identical property. With exceptions not relevant here, the term "appreciated financial position" means any position with respect to any stock, debt instrument, or partnership interest if there would be gain were such position sold, assigned, or otherwise terminated at its fair market value. (§1259(b)(1)) A "forward contract" is a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price. (§1259(d)(1))

In Revenue Ruling 2003-7, 2003-1 CB 363, IRS recognized that VPFCs are open transactions when executed and do not result in the recognition of gain or loss until future delivery. The rationale is that a taxpayer entering into a VPFC does not know the identity or amount of property that will be delivered until the future settlement date arrives and delivery is made. (Here in this case, the treatment of the original VPFCs was not in dispute: both parties (IRS and McKelvey's estate) agreed that when the original VPFCs were entered into in 2007, the contracts satisfied the requirements of Revenue Ruling 2003-7, and no current gain or loss was recognized.

In *Virginia Iron Coal & Coke Co.* (1938), 37 BTA 195, aff'd, (CA4 1938) 21 AFTR 1221, cert denied 1939 (Virginia Coal), the taxpayer wrote an option in exchange for an upfront cash premium. The option contract provided the optionee with the right to extend the option from year-to-year by making annual payments to the taxpayer on or before the first day of August. The optionee failed to make a timely extension payment for the third year, which allowed the option to lapse. However, the parties modified the option and agreed to continue it. The Board of Tax Appeals held that the continuation of the option prevented the taxpayer from realizing gain or loss in the year of lapse because the taxpayer maintained a continuing obligation to perform. The Board of Tax Appeals also reasoned that continuing open transaction treatment was appropriate because it was uncertain whether the premium payments would ultimately be included in the computation of gain or loss from the sale of the underlying property or would constitute income to the taxpayer in connection with the expiration of the option.

In *Freddie Mac,* (2005) 125 TC 248, the taxpayer entered into prior approval purchase contracts to purchase mortgages from loan originators in exchange for a nonrefundable commitment fee. IRS argued that the upfront commitment fees did not constitute option premiums because it was a virtual certainty that the transactions would be consummated. The Tax Court first found that the prior approval purchase contracts had the economic substance of options and so applied the law and policy rationale governing options. Despite the high level of certainty that a transaction would be consummated, the Court held that some uncertainty remained whether the loan originator would exercise the right to sell the mortgage to the taxpayer, and whether the option was exercised or allowed to expire affected the tax treatment of the upfront premiums. The Tax Court found that there was not a sale or exchange and approved open transaction treatment.

Andrew McKelvey, the founder and chief executive officer of Monster Worldwide, Inc. (Monster)-a company known for its website, monster.com, which helps inform job seekers of job openings that match their skills and desired geographic location-entered into VPFCs (original VPFCs) with two investment banks in 2007. Under the terms of the original VPFCs, the investment banks made prepaid cash payments to McKelvey, and McKelvey was obligated to deliver variable quantities of stock to the investment banks on specified future settlement dates in 2008 (original settlement dates). McKelvey treated the execution of the original VPFCs as open transactions pursuant to Revenue Ruling 2003-7 and did not report any gain or loss for 2007.

In 2008, before the original settlement dates, McKelvey paid consideration to the investment banks to extend the settlement dates until 2010 (VPFC extensions). McKelvey did not report any gain or loss upon the execution of the VPFC extensions and continued the open transaction treatment.

McKelvey died in 2008 after the execution of the VPFC extensions.

On audit, IRS determined that the execution of the VPFC extensions in 2008 constituted sales or exchanges of property under §1001 and that McKelvey accordingly should have reported gain from the transactions for 2008.

The Tax Court held that McKelvey's execution of the VPFC extensions did not constitute sales or exchanges of property under §1001, and the open transaction treatment afforded to the original VPFCs under Revenue Ruling 2003-7 continued until the transactions were closed by the future delivery of stock.

The Tax Court reasoned that, in Virginia Coal and Freddie Mac, it approved open transaction treatment because it was uncertain whether the options would be exercised or allowed to expire, and the uncertainty directly affected the taxpayer's treatment of the upfront option premium. In the current case, ample uncertainty existed regarding the nature and amount of the gain or loss. When McKelvey entered into the original VPFCs, he had the right to receive a cash prepayment in exchange for his obligation to deliver an undetermined number of Monster shares or cash equivalent. Although the amount of the prepayment was known to the parties at inception, the amount and character of gain or loss could not be determined until he determined what property he would deliver at settlement. If he delivered Monster shares in settlement of the VPFCs, the gain or loss would be determined by comparing the amount realized (i.e., the prepayment cash) with the basis in the particular shares delivered, and the character of the gain or loss would be determined by the holding period of the shares delivered. If he delivered a cash equivalent to settle the VPFCs, the gain or loss would have been determined by comparing the amount realized (i.e., the prepayment cash) to the amount paid to settle the contract. This uncertainty existed with respect to the original VPFCs, and the extensions to the VPFCs did not resolve what property McKelvey would deliver at settlement.

In addition, the Court further held that McKelvey did not engage in constructive sales of stock in 2008 under §1259.

The Tax Court reasoned that McKelvey's extensions to the original VPFCs did not constitute constructive sales under §1259 because the original VPFCs were the only contracts subject to evaluation. And IRS had acknowledged that his execution of the original VPFCs satisfied Revenue Ruling 2003-7. Implicit in this acknowledgment is that the original VPFCs did not trigger constructive sales of stock under §1259 because the original VPFCs required the future delivery of Monster stock subject to significant variation. IRS's argument that the extensions to the original VPFCs triggered constructive sales was predicated upon a finding that there was an exchange of the extended VPFCs for the original VPFCs under §1001. The Court said that, as it concluded above, the open transaction treatment afforded to the original VPFCs continued when McKelvey extended the settlement and averaging dates, and there was no exchange of property under §1001. Accordingly, because IRS conceded that the original VPFCs were properly afforded open transaction treatment under §1001 - and because the open transaction treatment continued when McKelvey executed the extensions- there was no merit to IRS's contention that the extended VPFCs should be viewed as separate and comprehensive financial instruments under §1259.

McNeill v. U.S., (DC WY 2/24/2017) 119 AFTR 2d ¶2017-483.

On remand from the Tenth Circuit, a district court has held that a taxpayer who participated in a distressed asset debt (DAD) tax shelter was not liable for accuracy-related penalties. The court concluded that the overall facts of the case, including the taxpayer's knowledge of tax law, efforts to assess the proper tax liability, and reliance on tax advice of qualified professionals, showed that he acted reasonably and in good faith within the meaning of §6664(c).

Under §6664(c)(1), a penalty under §6662 or §6663 will not apply to any portion of an underpayment if it is shown that there was reasonable cause for that portion and that the taxpayer acted in good faith; both of those defenses can potentially be established by, among other things, reliance on the advice of a tax professional. (*U.S. v. Boyle,* (S Ct 1985) 55 AFTR 2d 85-1535)

When he approached his retirement, Corbin McNeill, a former Navy Commander turned utility company executive, found himself slated to receive an $18 million payment which would generate a correspondingly large tax bill. McNeill entered into a complicated partnership-based DAD transaction and tax strategy to reduce the taxes owed. Before doing so, he consulted with a number of individuals about the actual strategy itself as well as the reputation of the company implementing it, including tax advisers at a Big 4 accounting firm and attorneys at a law firm that provided a tax opinion letter on the strategy.

IRS determined that the strategy was an abusive tax shelter, disallowed the tax benefits from it (namely, a $20 million paper loss) and imposed accuracy-related penalties under §6662. McNeill paid the deficiency and penalties but sought a refund of the penalties on the basis that he reasonably relied in good faith on the professional opinions and actions of competent tax and legal advisors.

The district court determined that McNeill was precluded under the TEFRA partnership procedures from asserting a reasonable cause/good faith defense at the partner level because such a defense had already been asserted and rejected at the partnership level. (*McNeill v. U.S.,* (DC WY 2015) 116 AFTR 2d 2015-5373) However, the Court of Appeals for the Tenth Circuit reversed the district court and remanded the case for determination of whether McNeill could, on the merits, avoid penalties under §6664(c)(1).

The district court, while noting that the case "presents a close call," found that McNeill had reasonable cause and acted in good faith.

The court first considered McNeill's knowledge as a taxpayer, finding that while he was an intelligent and accomplished businessman, in the context of the scheme in this case-a complex strategy designed and implemented by investment managers and tax lawyers to exploit the Code's partnership provisions-he was not knowledgeable or sophisticated.

Given his lack of knowledge or sophistication about a partnership-based DAD transaction, the court then turned to whether the efforts that McNeill took to assess his proper tax liability were reasonable. McNeill obtained a positive independent opinion from a qualified advisor about the entity promoting the strategy and about the overall track record of the investment manager. He sought tax advice and received two separate unequivocally positive indicators from qualified lawyers and tax advisors that the strategy "worked," in that the anticipated tax loss from the strategy was compliant and lawful under the partnership tax code sections. He also obtained a tax opinion from a law firm. The court rejected IRS's challenges to the law firm opinion, including that the firm was not independent of the transaction and that the opinion was based on unsupported assumptions, finding that McNeill did not know of any conflict of interest and that such challenges were otherwise insufficient to show that McNeill's reliance was unreasonable.

IRS also asserted that McNeill made representations to the law firm that were false, including that he had the opportunity to make a return on his investment without regard to tax benefits and that his decision to enter the transactions was based on their economics. While the court found that these representations were not true, it found that they were consistent with his understanding of the scheme and what he was told about it.

The court also rejected IRS's claim that McNeill should have known that the transaction, which promised "too good to be true" tax benefits, was abusive. The court concluded that, given McNeill's level of sophistication with respect to the transaction, he independently investigated it and was consistently told that it was legitimate-by people who owed him a fiduciary duty to provide objective, professional advice and who "knew the partnership tax provisions well enough to paper the deal to their satisfaction."

U.S. v. Moore, DMD PA, et al., (DC NJ 8/29/2017) 120 AFTR 2d ¶ 2017-5188

A district court has granted IRS default judgment with regard to the unpaid federal tax liabilities of a husband and wife and of the husband's solely owned and operated dental practice. However, the court denied IRS injunctive relief that would have forced a shutdown of the husband's dental practice and stopped him from practicing dentistry entirely until the tax liabilities were paid.

An employer is liable for the payment of income tax required to be deducted and withheld from wages paid to employees. (§3403) Similarly, an employer must deduct and withhold employees' FICA tax. (§3102(a)) Employers are also liable for and must pay their own FICA tax (§3111) and a federal unemployment (FUTA) tax based on wages paid to their employees. (§3301)

Employers also must file Form 941 (Employer's Quarterly Federal Tax Return) on at least a quarterly basis, and file Form 940 (FUTA Tax Return) with IRS on an annual basis. (§6011) In addition, an employer must make periodic deposits of the withheld federal income and employment taxes in a federal depository bank. (§6302, §6157, Regulation §31.6302-1)

Under §6672(a), if an employer fails to properly pay over its payroll taxes, IRS can seek to collect a trust fund recovery penalty equal to 100% of the unpaid taxes from a person who: (1) is a responsible person-i.e., one who is responsible for collecting, accounting for, and paying over payroll taxes (such as the sole owner and operator of a company); and (2) willfully fails to perform this responsibility.

§7402(a) provides that district courts have the jurisdiction to make and issue orders of injunction, and to render such judgments and decrees as may be necessary or appropriate for the enforcement of the internal revenue laws. These remedies are in addition to and not exclusive of any and all other remedies.

Under §7402(a), courts must determine if injunctive relief is necessary and proper "in light of the public interest involved." (*U.S. v. First Nat'l City Bank, (S Ct 1965) 15 AFTR 125)*. Although the Third Circuit (to which this case would be appealable) has not set a standard for issuing or modifying an injunction under §7402(a), other courts have suggested ways to guide the analysis. (*U.S. v. Baker Funeral Home, Ltd.,* (E.D. Pa. 2016) 118 AFTR 2d 2016-5311) That includes whether the party is "reasonably likely to violate the federal tax laws again" based on "the totality of the circumstances surrounding the defendant and his violations." (*U.S. v. ITS Fin., LLC,* (CA 6 2014) 114 AFTR 2d 2014-6665)

Since the late 1970s, Dr. Richard Moore has solely owned and operated a dental practice called Richard A. Moore, DMD PA, d/b/a A Gentle Fast Orthodontic Care, (the Dental Practice) which employed several people.

In 1995, IRS opened its first collection case against the Dental Practice for unpaid employment taxes over the three previous years. IRS levied the payments from Dr. Moore's insurance company. In January of 1998, IRS entered into an installment payment agreement with Dr. Moore after the Dental Practice accrued more tax liabilities in 1997. But the Dental Practice failed to make federal tax deposits in 1998 and 1999, and Dr. Moore defaulted on the installment payment agreement after issuing bad checks.

Nine years later, in May 2007, the IRS reinstated the installment payment agreement, but the Dental Practice again defaulted. In January of 2009, IRS reinstated the agreement a final time, but the Dental Practice defaulted yet again.

In 2007, IRS opened its first tax collection case against Dr. Moore personally. Since the 2009 tax year, Dr. Moore has not filed a federal income tax return or voluntarily paid any income taxes. In March of 2009, IRS entered into an installment payment agreement with Dr. Richard A. Moore, and Genna K. Moore a/k/a Genna K. Gunta (the taxpayers) for their unpaid 2007 income tax liabilities. But they defaulted a few months later.

In February of 2012, IRS issued a summons to the Dental Practice for testimony and financial records in connection with an investigation into its prior tax liabilities. Dr. Moore did not comply, so IRS successfully petitioned the district court to enforce the summons. Dr. Moore refused to produce the summonsed records and appear in court, so the district court issued a warrant for his arrest. After Dr. Moore's arrest and a subsequent hearing, Dr. Moore provided the required documents to IRS.

On September 28, 2016, IRS filed this lawsuit against the taxpayers. IRS asserted that they failed to pay several types of federal taxes related to the Dental Practice. From 2007 to 2010, IRS claimed that Dr. Moore failed to (1) withhold and pay to IRS his employees' federal income and FICA taxes and the Dental Practice's FICA and FUTA taxes; (2) deposit those taxes in a federal depository bank; and (3) file with IRS the Dental Practice's quarterly Federal Tax Returns (IRS Form 941) and annual FUTA Tax Returns (IRS Form 940). From 2007 to 2009, the Moores did not pay their Federal Income Taxes, and Dr. Moore alone did not pay in 2010.

IRS also sought injunctive relief under §7402(a), which permits district courts to enter injunctions to ensure enforcement of the internal revenue laws. IRS claimed that an injunction was warranted because the taxpayers have refused to cooperate with IRS for over 20 years. Specifically, IRS sought a permanent injunction as follows:

1. Dr. Moore may not directly or indirectly own, control, manage, operate; consult for, or serve as an officer or employee in any dental or orthodontic practice until the earlier of 1) Dr. Moore's demonstration to this Court that he is likely to resume operating without interfering with the enforcement of the internal revenue laws, or 2) five years from the entry of the permanent injunction in this case; and

2. Dr. Moore and Richard A. Moore, DMD PA and their principals, agents, or employees, and all attorneys, agents, and employees, and anyone else acting on behalf of those individuals or entities, and all persons or entities having knowledge of this Order, shall not, directly or indirectly transfer, sell, assign, pledge, hypothecate, encumber, dissipate, or dispose of in any manner any money, property, or assets until Richard A. Moore, DMD PA has filed all outstanding Form 941 and Form 940 tax returns and paid the taxes owed.

The taxpayers failed to answer or otherwise defend the action.

The district court found that, save for the requested injunctive relief, there was sufficient facts (taken as true) to find that the taxpayers were liable for the tax liability IRS asserted.
IRS had issued assessments of tax liability on the Dental Practice and Dr. Moore and provided them notice of these assessments. The court noted that since assessments of a tax liability by the IRS are generally presumed valid and establish a prima facie case of a tax liability, IRS had stated claims to recoup these liabilities.

Further, IRS had demonstrated that the failure to withhold and pay these taxes can be personally imposed on Dr. Moore under §6672, which imposes trust fund recovery penalties on corporate officers for the willful non-payment of employment tax liability owed by the corporation. IRS has alleged both that Dr. Moore was on notice of these liabilities and willfully evaded them.
In addition, IRS alleged the Dr. and Mrs. Moore owed but failed to pay their federal income tax over several years.

However, with regard to the injunction, the district court determined that the relief sought was overbroad and premature. The court noted that the cases cited by IRS in which the parties were enjoined from engaging in their livelihood all involved tax preparers who prepared incorrect tax returns for their clients. (*U.S. v. Pugh,* (E.D.N.Y. 2010) 105 AFTR 2d 2010-2662, *U.S. v. Franchi,* (W.D. Pa. 1991) 67 AFTR 2d 91-631) These cases were qualitatively different. In contrast to these cases, Dr. Moore's tax issues did not impact his patients. The continuation of his dental practice did not raise the same concerns as would the continuation of a faulty tax preparation service (where many of the preparer's clients would underpay their returns, and, as a result, be subject to IRS audit and penalty). Here, the district court did not find IRS's argument for irreparable harm credible.

The district court reasoned that such an injunction would force a shutdown of Dr. Moore's dental practice and stop him from practicing dentistry entirely until the tax liabilities were paid. Such a harsh result was not only unprecedented but also premature given that no efforts or supplemental proceedings had been taken to satisfy this judgment. Moreover, the proposed injunction looked more punitive than remedial; it would cut off Dr. Moore's only real chance to repay his and the practice's liabilities; and it did not take into consideration how the shutdown would impact his patients. As such, even though IRS had demonstrated Dr. Moore's history of noncompliance, it had not demonstrated that his conduct warranted the proposed injunction.

Accordingly, IRS's claim for injunctive relief was denied without prejudice.

Moss, TC Memo 2017-30.

Husband who alleged that his wife's mental illness led her to the delusion that she suffered a loss in the "Madoff fraud" was not entitled to file his return with a married filing jointly status. The husband had no formal power of attorney or similar authorization and could not claim that he properly filed a joint return with his wife as her agent. The wife, who refused to sign the joint return, filed a return as married filing separately.

Under §6012(b)(2), when a person is unable to make a return, "the return of such individual shall be made by a duly authorized agent, his committee, guardian, fiduciary or other person charged with the care of the person or property of such individual." Regulation §1.6012-1(a)(5) provides that reasons for which a person may be unable to make a return include disease, illness, or continuous absence from the U.S.

Regulation §1.6013-1(a)(2) provides that even when such a person is a disabled spouse, the would-be duly authorized agent must comply with the provisions of Regulation §1.6012-1(a)(5). These provisions require that the return be accompanied by (1) an IRS Form 2848 (Power of Attorney and Declaration of Representative), or, a power of attorney authorizing the agent to represent the taxpayer in making, executing, or filing the return; (2) a statement signed by the spouse who is signing the return confirming that the incapacitated spouse consents to the signing of the return; or (3) a request for permission from, and determination made by, the appropriate IRS district director that good cause exists for permitting an agent to submit the return. (Regulation §1.6012-1(a)(5))

Generally, both spouses must sign a joint return. (Regulation §1.6013-1(a)(2)) There are, however, two circumstances in which a return may be accepted as jointly filed even though it is signed only by one spouse: when a taxpayer acts as an authorized agent for his or her spouse, (Regulation §1.6061-1(a)), and when there is sufficient evidence that, despite the lack of a signature, the spouse consented to filing jointly. (*Estate of Campbell* (1971), 56 TC 1; *Strong,* TC Memo 2001-103)

Peter William Moss timely filed a 2008 joint income tax return. On the tax return, he claimed married filing jointly status and personal exemptions for himself and his wife. However, his wife refused to sign the 2008 return. He nevertheless filed the return and attached to it a letter stating that his wife was seriously mentally ill, that IRS should disregard all information she sent, and that the return included her income for 2008 as well as his. He did not attach any power of attorney that would authorize him to act on behalf of his wife.

Mr. Moss believed that Mrs. Moss's mental illness, for which she was hospitalized in 2005 and 2006, left her highly suggestible to news programs covering the "Madoff fraud" and led to the delusion that she had lost $350,000 in 2008. In fact, she had no investments affected by the Madoff fraud. By this time, Mr. Moss believed that he served in a guardianship function for his wife because a condition of her hospital release in 2006 was that she live with him. However, to avoid worsening the rift in their relationship caused by her hospitalization, he did not seek any official status as a conservator, holder of a power of attorney, or guardian of his wife.

Mrs. Moss never submitted to IRS any consent for Mr. Moss to file the 2008 return for her. Mrs. Moss apparently insisted on filing a separate return in April 2009 because she believed she was entitled to a theft loss deduction. On the 2008 return, she claimed a $350,000 casualty loss. The filing of a separate return was a significant departure for Mrs. Moss; the 2008 tax year was the only instance, from 1966 to 2011, in which she filed a separate return.

IRS accepted Mrs. Moss's return but apparently few, if any, of its figures. On December 2, 2011, IRS issued a notice of deficiency to Mr. Moss for the 2008 tax year, changing his filing status from married filing jointly to married filing separately and making computational and statutory changes to his standard deduction, the amount of taxable Social Security income, and disallowing one of his claimed personal exemptions. Initially, IRS included Mrs. Moss's income on his return, but eventually conceded that the deficiency amount should be reduced to reflect the removal of all income attributable to Mrs. Moss.

In August 2013, a Connecticut probate court placed Mrs. Moss into a conservatorship, appointing her daughters as conservators.

The Tax Court concluded that Mr. Moss was not entitled to file his return with a married filing jointly status. Because Mrs. Moss did not sign the return in issue, it did not comply with the requirements for a joint return under Regulation §1.6013-1(a)(2). Further, even if the Court were to conclude that Mrs. Moss was unable to file a return in 2009-which it did not-he was not her duly authorized agent. Mr. Moss, who had no formal power of attorney or similar authorization when he prepared the 2008 return, did not comply with the provisions of Regulation §1.6012-1(a)(5), and so could not claim that he properly filed a joint return with his wife as her agent.

The Court noted that while Mr. Moss contended that his wife could not file a valid return because of her mental illness, a person's previous commitment to a hospital and a spouse's assertion of mental illness were not sufficient to invalidate an individual's right to file his or her own return. The conservatorship order issued over four years after the return was filed did not satisfy his burden to prove that his wife was incapable of filing her own return in April 2009.

Furthermore, he did not show that he qualified as his wife's agent. He had no power of attorney or Form 2848 to attach to the return. He did not file a statement confirming that Mrs. Moss consented to the signing of the return. Indeed, he filed a statement that she refused to sign the return. At the time of the filing of the return, it appeared no one other than Mrs. Moss had the authority to file a return on her behalf. In addition, although Mrs. Moss was eventually placed in a conservatorship, Mrs. Moss' daughters, not Mr. Moss, were appointed as her conservators.

The Tax Court noted that, alternatively, a joint return may be found, even without a spouse's signature, if there is other evidence that the husband and wife intended to file a joint return. But, although Mr. and Mrs. Moss had a long history of filing jointly, there was no dispute that Mrs. Moss did not intend to file a joint return for the 2008 tax year. She expressly refused to sign the 2008 joint return and filed a timely return of her own. Because the evidence showed that Mrs. Moss intended not to file a joint return, the Court found that it could not find that Mr. Moss filed a joint return under the consent theory.

Mudrich, TC Memo 2017-101.

Husband's payment to his soon-to-be ex-wife of half of his bonus was not deductible as alimony. Although the couple entered an agreement to split the bonus, it was not a "divorce or separation instrument"; and the Court rejected the husband's argument that the payment was made pursuant to a support order, finding that the payment predated the support order and that the amount of the payment was not consistent with the formula provided in the order.

Generally, property settlements (or transfers of property between spouses) incident to a divorce do not give rise to deductions or recognizable income. (§1041) On the other hand, amounts received as alimony or separate maintenance payments are included in gross income and taxable to the recipient (§71(a)) and deductible by the payor in the year paid. (§215(a))

An alimony or separate maintenance payment is one that meets the following four requirements:

a. The payment must be made under a "divorce or separation instrument";

b. The instrument must not designate the payment as not includable in the recipient spouse's gross income under §71 and not deductible by the payor spouse under §215;

c The payor and payee spouses must not be members of the same household at the time the payments are made; and

d. The payor's obligation to make the payment must end at the death of the payee spouse. (§71(b)(1))

A "divorce or separation instrument" is defined in §71(b)(2) as a decree of divorce or a written instrument incident to such a decree, a written separation agreement, or a decree requiring a spouse to make payments for support or maintenance of the other spouse.

Paul Mudrich is an attorney who earned a $250,000 bonus in 2006 while married to Lauri Mudrich. He filed for divorce from Lauri in January, 2007.

Paul received the bonus in 2007, the year at issue, while still married to Lauri. After tax withholding, the amount of the bonus was $156,618, and he paid approximately half of it to Lauri on May 18, 2007 (bonus payment). On May 21, 2007, Lauri signed an agreement (the bonus agreement) providing that the bonus was community property that Paul would pay her one-half of the bonus net of withholding, and that he would report the entire bonus on his return. He signed the bonus agreement on June 18, 2007.

Their marriage was terminated on August 8, 2007, and the superior court issued a spousal support order. The support order provided that Paul would pay Lauri $3,270 per month in temporary support, as well as 31.3% of any income her earned in excess of $12,500 per month. The support order did not mention the bonus payment.

On his 2007 return, Paul, filing jointly with his new spouse, claimed a $127,228 alimony deduction representing the bonus payment, seven monthly temporary support payments, and a remaining amount that he subsequently conceded was not alimony. IRS challenged his treatment of the bonus payment as alimony.

The Tax Court found that the bonus payment was not made pursuant to a divorce or separation instrument and thus was not alimony. The Court found no evidence that the bonus agreement ever became an order in the divorce proceeding, and further noted that the bonus agreement was not a written separation agreement. A written separation agreement has been interpreted to require a clear, written statement memorializing the terms of support between the parties and entered into in contemplation of separation status. (*Jacklin*, (1982) 79 TC 340) The bonus agreement, however, merely provided for a division of community property and not support.

In addition, the Court concluded that the bonus payment was not made pursuant to the support order. The amount of the bonus payment was wholly consistent with the calculation set out in the bonus agreement, and not with the formula set out in the support order. Moreover, the bonus payment predated the support order, and the Court noted that it "is well established that payments made before the existence of a written divorce or separation instrument are not deductible as alimony." (*Ali,* TC Memo 2004-284) The Court found that Paul also failed to prove that he and Lauri lived separately or were legally separated at the time the bonus payment was made, as required under Code §71(b)(1).

Musa, (CA 7 4/26/2017) 119 AFTR 2d ¶ 2017-706.

The Court of Appeals for the Seventh Circuit has affirmed the Tax Court's finding that the "duty of consistency" prevented an employer from receiving an income tax deduction for wages that he paid but did not report on any income or employment tax return until he reported them on an amended employment tax return that was filed after the expiration of the statute of limitations (SOL) for assessing employment tax on the wages. The Court also approved of the Tax Court's allowing IRS to make the duty of consistency argument in an amended answer.

The duty of consistency is an equitable tax doctrine analogous to judicial estoppel, which prevents a party from prevailing in a court proceeding by taking one position and then taking a contradictory position in a later case. The duty of consistency applies when there have been: (1) a representation or report by the taxpayer; (2) on which IRS has relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm IRS. (*Kielmar,* (CA 7 1989) 64 AFTR 2d 89-5677)

Rule 41(a) of the Rules of Practice and Procedure of the Tax Court provides: "A party may amend a pleading once as a matter of course at any time before a responsive pleading is served...Otherwise a party may amend a pleading only by leave of Court or by written consent of the adverse party, and leave shall be freely given when justice so requires."

In general, IRS may assess an employment tax or associated penalty only within three years after the return is filed. (§6501(a))

The taxpayer, Mr. Musa, owned a restaurant during the years at issue, i.e., 2006-2010. He omitted large amounts of the restaurant's revenues on his income tax return. He also paid some of his family member employees in cash and did not report these payments on his employment tax returns.

Observation: Although the case did not say so directly, it appears that he also did not deduct these payments to his family members on his income tax return.

On August 21, 2012, IRS sent Musa a Notice of Deficiency for tax years 2006 to 2010. Musa then petitioned the Tax Court for a redetermination of his tax deficiency. On September 23, 2013, Musa responded to IRS's discovery request and provided a spread sheet listing employees who he claimed had been paid additional wages but who were not previously included in the restaurant's employment tax returns. Over the next few months, the restaurant submitted amended quarterly employment tax returns for 2006 to 2010. Based on these amended returns, Musa sought additional deductions from his income tax liabilities. Musa provided copies of these amended statements to the IRS auditor on January 10, 2014.

A month later, in a conference call with the Tax Court and Musa, IRS raised the affirmative defense of the duty of consistency. It argued that the doctrine prevented Musa from claiming new expense deductions on his income tax returns for wages paid between 2006 and 2009 because IRS had relied on those representations and because the period for assessing employment taxes on those wages had expired. IRS also made this argument in its pretrial memorandum on February 24, 2014.

Because the duty of consistency is an affirmative defense, IRS sought and was granted leave to amend its answer in March 2014. IRS also sought partial summary judgment on this defense, and the Tax Court ruled in its favor on March 27, 2014.

Musa then brought this case, challenging both the Tax Court's decision to allow IRS to amend its answer and the Tax Court's application of the duty of consistency.

The Seventh Circuit held that the Tax Court did not abuse its discretion in allowing the amendment.

The Circuit Court first noted, citing *Kramer,* (1987) 89 TC 1081, that Tax Court Rule 41(a) was derived from Rule 15(a) of the Federal Rules of Civil Procedure and that the two rules should be interpreted in a similar manner. And, it said that Civil Rule 15(a) requires courts to allow amendment unless there is a good reason-futility, undue delay, undue prejudice, or bad faith-for denying leave to amend.

The Court rejected Musa's claims that he was "unduly prejudiced" when the Tax Court permitted IRS to amend its pleading. IRS raised the issue during the February 2014 conference call, i.e., more than three months before trial, and sought leave to amend its answer more than two months before trial. This was no last-minute surprise on the part of IRS. Moreover, since Musa did not make clear in his original petition that he would seek additional deductions based on his payments of previously unreported wages, IRS had no grounds to raise the duty of consistency until it actually raised it. Musa's approach would unfairly penalize IRS for Musa's own delays and false tax returns.

The Seventh Circuit also rejected Musa's argument that the Tax Court misapplied the duty of consistency. The Court found that IRS met each of the three elements of the duty.

First, Musa made representations on the various tax forms he filed, including the restaurant's quarterly employment tax returns for 2006 to 2009 and the W-2 and W-3 forms provided to the restaurant's employees and IRS. In his initial filings, Musa represented that the restaurant paid employees the following sums in non-tip wages from 2006 to 2009, respectively: $28,248; $18,900; $30,993; and $70,890. Then in the fall of 2013, Musa amended his filings to identify additional wages that he had paid to employees but failed to report for those same years.

Second, IRS relied on the original representations because IRS assessed employment taxes based on Musa's original reports of employee wages in the restaurant's quarterly employment tax returns.

Musa argued that IRS did not rely on the employment returns because IRS should have known they were inaccurate. This is so, Musa claimed, because IRS had "all facts available to [it]" or had the "opportunity to gain such knowledge" prior to the expiration of the statute of limitations. In other words, the Court said, Musa argued that after IRS discovered his income tax fraud and he submitted amended income tax returns, IRS should have induced from the amended income tax returns that the restaurant's quarterly employment tax returns had also been incorrect.

The Court said that there was no merit to Musa's claim that IRS lost its ability to rely on Musa's employment tax returns because Musa amended his income tax returns. "Ours is a self-reporting system of taxation, and for that system to function, IRS must be able to rely on truthful reporting."

Third, failing to hold Musa to the duty of consistency would harm IRS. The assessment period for the restaurant's employment tax returns for 2006 to 2008 expired before IRS could assess additional taxes based on the amended employment tax returns. Since IRS could not collect additional taxes based on Musa's amended employment tax returns, it was harmed.

Nielsen, TC Summary Opinion 2017-31.

Where taxpayers sought to depreciate rental real estate, the Tax Court has rejected the taxpayers' allocations of costs between depreciable (buildings) and nondepreciable (land) property. The Court concluded that the allocations made by IRS based upon county tax assessments were more reliable and persuasive than the allocation methods suggested by the taxpayers.

Under §167(a), a taxpayer is allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear, and tear of property used in a trade or business. Under §168(a), the depreciation deduction for any tangible property is generally determined by using the applicable depreciation method, the applicable convention, and the applicable recovery period.

Depreciation is generally computed by using the cost of the property as its basis. (§167(c), §1011, §1012, Regulation §1.167(g)-1) If depreciable property and nondepreciable property-such as land with improvements- are bought for a lump sum, the cost must be apportioned between the land and the improvements. (*U.S. v. Hill*, (S Ct 1993) 71 AFTR 2d 93-578, Regulation §1.167(a)-5) In making this allocation, Regulation §1.167(a)-5 provides that, in the case of the acquisition on or after March 1, 1913, of a combination of depreciable and nondepreciable property for a lump sum-for example, buildings and land-the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time. The relevant inquiry is the respective fair market values of the depreciable and nondepreciable property at the time of acquisition. (*Weis,* (1990) 94 TC 473, *Randolph Bldg. Corporation ,* (1977) 67 TC 804)

In 2012, Sharon and Steve Nielsen owned several rental real estate properties (rental properties) in California: the 7756 Newlin property, which was purchased in 2003 and at that time had three buildings on it; the Camilla property, which was purchased in 2003 and which at that time had four buildings on it; and the 6522 Newlin property, which was purchased in 2011 and at that time had two buildings on it.

In 2012, the Los Angeles County Office of the Assessor (L.A. Assessor) assessed the 7756 Newlin property at a value of $425,324, of which amount $189,032 was attributable to improvements and $236,292 was attributable to land. Thus, according to the tax assessor's office, the value of the improvements constituted 44.4% of the total value of the property.

In 2003, Hawthorne Savings (Hawthorne) performed a professional appraisal of the Camilla property and determined a value of $750,000, attributing $255,486 to improvements and the balance to land. Thus, according to the Hawthorne appraisal, the improvements constituted 34% of the total value of the property. In 2012, the L.A. Assessor assessed the Camilla property at a value of $795,000, of which amount $305,800 was attributable to improvements and $489,200 was attributable to land. Thus, according to the L.A. Assessor's office, the value of the improvements constituted 38.4% of the total value of the property.

In 2013, the L.A. Assessor assessed the 6522 Newlin property at a value of $532,807, of which amount $163,940 was attributable to improvements and $368,867 was attributable to land. Thus, according to the L.A. Assessor's office, the value of the improvements constituted 30.7% of the total value of the property

On Schedule E (Supplemental Income and Loss) attached to their 2012 return, the taxpayers claimed depreciation deductions for the rental properties using the straight-line method of depreciation with a recovery period of 27.5 years. In their calculations of depreciable basis for the rental properties, they included the cost of the land and improvements.

IRS disallowed a portions of their depreciation deductions on the grounds that they had incorrectly included the cost of the nondepreciable land in their calculations of depreciable basis for the rental properties. It redetermined the depreciable basis of each rental property according to an apportionment of value between improvements and land based on the L.A. Assessor's assessments.

In court, the taxpayers agreed that the value of the land should not have been included in their calculations of the depreciable bases of the rental properties. However, they contended that IRS's allocations as to land values were excessive. They challenged the accuracy and credibility of IRS's reliance on the L.A. Assessor's assessments and instead relied on two alternative methods of valuation: (1) land sales method and (2) insurance method.

Observation: Although the Tax Court did not discuss the alternate valuation methods suggested by the taxpayers beyond mentioning them, presumably the land sales method referred to arriving at a valuation of the depreciable portion of property by reviewing comparable sales of raw land (without any depreciable improvements), and the insurance method referred to arriving at a valuation of the depreciable portion of property based upon the replacement value of the improvements as determined by a various insurance companies.

The Tax Court found that, as between the taxpayers' allocations and the allocations based upon the L.A. Assessor's assessments, the latter was the more reliable and persuasive. The Court also noted that the Hawthorne appraisal and allocations with respect to the Camilla property supported this finding. Accordingly, the taxpayers' allowable depreciation deductions were limited to the amounts allowed by IRS.

To back up their assertion that the L.A. Assessor's data "is extraordinarily inaccurate" and internally inconsistent, the taxpayers presented an October 4, 2012 letter from the chief deputy assessor for the L.A. Assessor to the chief executive officer of the County of Los Angeles that identified "critical tasks requiring immediate attention." The October 4, 2012 letter described plans to upgrade the L.A. Assessor's information technology to replace "existing systems which no longer provide the required functionality and reliability" and improve access to the Multiple Listing Service to increase the accuracy of appraisals.

The Tax Court stated that it had carefully reviewed the record, including the October 4, 2012, letter and a document titled "Parcel Detail--Los Angeles County Assessor Portal" on which the taxpayers relied. However, the Court concluded that it did not share the taxpayers' concerns with respect to the unreliability of the L.A. Assessor's assessments.

Nor did the Tax Court give much weight to the after-the-fact allocations that the taxpayers proposed. Although the Court acknowledged that the owner of property was qualified by his ownership alone to testify as to its value, it was unaware of any authority that suggested that this qualification extended to an allocation of the value of property between land and improvements.

Omega Forex Group, LC v. U.S., (DC UT 3/8/2017) 119 AFTR 2d ¶2017-519.

A district court has upheld IRS's disallowance of partnership losses claimed by a taxpayer, finding that the taxpayer did not actually engage in any at-risk financial activity and that amounts that he claimed were capital contributions to the partnership were contributions to an account which he drew from freely. The court also upheld IRS's imposition of a fraud penalty and found that the limitations period on assessments remained open.

Taxpayers may sustain a loss when: 1) their property is transferred, stolen, destroyed, confiscated, abandoned, taken by foreclosure or becomes worthless; and 2) they receive less than adequate compensation for it. This loss may be deductible if certain conditions are met.(§165) In general, deductions from certain investment activities are limited to the aggregate amount the taxpayer-investor has at risk.(§465) A taxpayer's amount at risk includes cash contributions and certain amounts borrowed with respect to the activity for which the taxpayer is personally liable for repayment or for which the taxpayer has pledged property, other than property used in the activity, as security for the borrowed amounts.(§465(b)(2)) A loss from an activity subject to the "at-risk" rules is deductible in the loss year only to the extent that taxpayer is at risk with respect to the activity at the end of the year. (§465(a)(1))

A civil penalty of 75% is imposed on the portion of any underpayment of tax required to be shown on a return that is attributable to fraud. (§6663) However, the penalty does not apply to any portion of an underpayment for which the taxpayer acted with reasonable cause and good faith. (§6664)

Robert Flath was a college graduate, a former naval officer, and a private dentist. On his 1998 return, Flath claimed a pass-through loss of $149,857, passed through by Omega Forex (Omega) as Flath's share of a $4.7 million loss allegedly sustained in currency speculation. The 1998 K-l stated that Flath had contributed capital during 1998 of $200,000, and that his capital account at the end of the year was $49,881.

Although Omega's books and records for 1998 showed a note receivable from Flath, he denied ever signing a note-and regardless, never paid it in 1998. The only payment made by Flath relating to his capital contribution was a payment of a $20,000 fee paid to Dennis Evanson, his "tax expert," to become a capital contributing member of Omega. The court noted that Evanson received an initial $20,000 fee for his role and was thereafter to be paid on a contingency basis, receiving 20% of all tax savings provided to Flath, and receiving nothing if the currency speculation produced a profit.

Early in 1999, Flath transferred marketable shares of stock to Omega, and the shares were liquidated in March or April of that year for $165,000. By what the court referred to as "some special form of bookkeeping slight of hand," the $165,000-less a fee to Evanson-ended up in a protector account in a Cayman Island entity that was controlled by Evanson but subject to the will of Flath (the Cayman account). In other words, the capital contribution, whenever it was made, passed through to the Cayman Island entity for the benefit of Flath, who suffered no loss at all. Flath kept substantially all of his capital contribution less Evanson's fee and kept close tabs on the Cayman account, drawing from it for stock purchases and other expenses.

After receiving his K-l for 1998, Flath consulted with Gail Anger, a certified public accountant, to assist him in filing his 1998 return. Anger was apprehensive about the loss deduction and did not think IRS would allow it, and stated in a letter that the return was prepared in reliance on Flath's assurance that he had at least the amount of the loss deduction at risk. Flath did not tell Anger about the Cayman account.

The 1999 K-1 provided to Flath showed a beginning capital account balance of $49,881, a capital contribution of $100,000, and a year-end capital account balance of $64,088. The K-l also showed Flath's share of loss to be $85,793. The $100,000 capital contribution was the result of what the court called "creative bookkeeping." Flath purportedly bought a secondary malpractice policy from a company with an $8,000 monthly premium (the court noted that the primary policy was $1,400 per year). The $8,000 monthly premium payment amount, less a fee to Evanson, was periodically transferred to Flath's Cayman account from which he continued to draw upon.

IRS issued Notices of Final Partnership Administrative Adjustments (FPAAs) for 1998 and 1999 to Omega disallowing the losses and imposing a fraud penalty. Omega filed a petition for relief, seeking a refund of the amount Flath paid and a determination that the FPAAs were invalid or incorrect.

The issue before the court was whether or not Flath intended to defraud the U.S. of rightfully owed taxes for 1998 and 1999. In his defense, Flath asserted he relied on "expert advice"-namely, Evanson, Anger, and another CPA- and that such negates fraudulent intent.

The court easily concluded that Flath acted with fraudulent intent and denied the relief sought.

The court determined that, in reality, Evanson was providing Flath with tax deductions purportedly from unsuccessful currency speculations in respect to funds that were not actually at risk. The transaction merely provided Flath (through Omega) with losses in exchange for a fee. The nature of the funds as not being at-risk was established by fact that they were used by Flath during the years at issue to buy stocks and pay family expenses.

The court also rejected Flath's claim that he acted reasonably and in good faith. It found that he did not actually rely on Evanson's expertise as to the legitimacy of the transaction, noting "[i]t is a strange form of "expertise" which suggests one may still spend what is lost." The court also rejected Flath's purported reliance on Anger and the other CPA, finding that he failed to provide them with accurate and complete information.

Accordingly, the court upheld the adjustments in the FPAAs that disallowed the fraudulent losses and imposed the fraud penalty.

Owens, TC Memo 2017-157.

An individual was determined to be involved in the trade or business of lending money and his advances to a company during those years constituted bona fide debt that became worthless in 2008. Accordingly, the taxpayer was entitled to his claimed bad debt deduction under §166.

§166(a)(1) allows as a deduction the amount of any bona fide debt that becomes worthless within the tax year. However, for nonbusiness bad debt held by a taxpayer, other than a corporation, §166(a)(1) does not apply, and the taxpayer is only allowed a short-term capital loss for the tax year in which the debt becomes completely worthless. (§166(d)(1), Regulation §1.166-5(a)(2)) Thus, §166 requires that: (1) the debt be created or acquired in connection with the taxpayer's trade or business; (2) a bona fide debt existed between the taxpayer and his debtor; and (3) the debt became worthless in the year the bad debt deduction was claimed.

The Tax Court has developed a non-exhaustive list of facts and circumstances to consider in deciding whether a taxpayer is in the business of lending money:

a. The total number of loans made;
b. The time period over which the loans were made;
c. The adequacy and nature of the taxpayer's records;
d. Whether the loan activities were kept separate and apart from the taxpayer's other activities;
e. Whether the taxpayer sought out the lending business;
f. The amount of time and effort expended in the lending activity; and
g. The relationship between the taxpayer and his debtors. (*Cooper*, TC Memo 2015-191)

Whether a purported loan is a bona fide debt for tax purposes is determined from the facts and circumstances of each case, including:

a. The names given to the certificates evidencing the indebtedness;
b. The presence or absence of a maturity date;
c. The source of the payments;
d. The right to enforce the payment of principal and interest;
e. Participation and management;
f. A status equal to or inferior to that of regular corporate creditors;
g. The intent of the parties;
h. "Thin" or adequate capitalization;
i. Identity of interest between creditor and stockholder;
j. Payment of interest only out of "dividend" money; and

k. The ability of the corporation to obtain loans from outside lending institutions. (*A.R. Lantz Co.* (CA9, 1970) 25 AFTR 2d 70-917)

The Tax Court has identified a number of objective criteria that indicate a debt is worthless:

a. A decline in the debtor's business;
b. A decline in the value of the debtor's assets;
c. Overall business climate;
d. Serious financial hardship suffered by the debtor;
e. The debtor's earning capacity;
f. Events of default;
g. Insolvency of the debtor;
h. The debtor's refusal to pay;
i. The actions taken by the creditor to pursue collection; and
j. Subsequent dealings between the creditor and debtor. (*Cooper,* TC Memo 2015-191)

In 2002, William Owens began a series of loan transactions with David Lohrey (Lohrey), who owned West Coast Linen-at the time the largest commercial laundry in the San Francisco Bay Area-which serviced the major hotel chains and numerous hospitals. Owens, who in addition to his responsibilities at Owens Financial Group, Inc. (OFG), his family's mortgage-broker company which arranged commercial loans, and the Owens Mortgage Investment Fund (Investment Fund), also made loans from his personal assets, and had done so since at least 1986. Funds for Owens's personal lending came from his trust, his pension plan account, and sometimes from a family limited partnership (FLP) that he managed with his two sisters.

Lohrey had previously sold his laundry business to Marriott (which renamed it Marriott Services). In 2002, Marriott sold Marriott Services to another company, Sodexo. Lohrey had continued to operate a commercial site in Gilroy through Lohrey Investments, LLC, which he leased to Marriott as a giant commercial laundry. Sodexo downsized and decided to close down the Gilroy laundry operation. Before it did so, Sodexo offered Lohrey an option to buy back the business. In 2003, Lohrey exercised this option and, in 2003, opened Lohrey Enterprises, d/b/a West Coast Linen.

Lohrey intended to resell or lease the business, but while attempting to do so, he had to make $90,000 monthly payments out of pocket. He fell behind on these payments and, upon advice of his attorney, Lohrey Investments filed for chapter 11 bankruptcy as a delaying tactic. During the bankruptcy Lohrey's attorney was able to negotiate a buyout at a lower price, However, Lohrey still needed to find the money to pay off the new loan and additional money to purchase equipment to make the laundry company a success.

After Owens had appraisals of Lohrey Investments' equipment drawn up and gathered Bank of America's appraisals of the Gilroy property, OFG made a $7.5 million loan to Lohrey Investments in July 2003, secured by a first deed of trust on the Gilroy property. A month later, Owens made a personal loan to Lohrey Investments for $2.75 million. The loan was funded by Owens Trust and the FLP, had a 15% interest rate, required monthly payments, and had a maturity date of September 2005. This loan was secured by a second deed of trust on the Gilroy property, and unlike OFG's loan to Lohrey Investments, it was a "participating" loan, giving Owens the right to participate in income over a certain threshold. (As Owens explained, this was something fairly typical when a lender took a junior position in a transaction.)

Owens forecasted that Lohrey Investments would be in "growth mode" for at least the next two years. West Coast Linen did begin to grow rapidly and won more contracts from the hotel industry. Lohrey Investments soon needed more equipment, and Owens was happy to keep the funds flowing. Everything went as planned with the first several loans, and Lohrey Investments kept up with its monthly payments, but then it fell behind. Lohrey hit a point with West Coast Linen where he needed cash flow to expand the business, to increase profit margins, and ultimately to pay off his creditors.

In December 2005, on the advice of an attorney, Owens entered into an operating agreement with Lohrey himself. The agreement made Owens' personal grantor trust, Owens Trust, a member of Lohrey Investments with a 30% share of profit, 99% share of loss, and 30% of capital. Despite what the operating agreement said, Owens' Schedules K-1 (Beneficiary's Share of Income, Deductions, Credits, etc.) for the 2006 and 2007 tax years reported him as having a 99% share of profit, 99% share of loss, and 99% of capital of Lohrey Investments.

Later in 2005, Lohrey approached Owens for a $20 million loan to pay off old debt and expand the laundry again. But Owens and OFG were tapped out. Instead, Vestin Mortgage, Inc. (Vestin) lent funds to Lohrey Investments but, because of the risk involved, required Owens to subordinate his own loans to Vestin. Owens agreed.

In June 2006, Vestin lent $16 million to Lohrey Investments secured by the Gilroy property and the equipment within it. Lohrey Investments used part of the Vestin loan to fully repay OFG, but not Owens's personal loan. In anticipation of a large contract with Kaiser, Lohrey Investments also used Vestin's money to buy more equipment to handle more laundry. The business started to grow, and West Coast Linen then won other contracts and bought even more equipment. Cash flow grew but not as quickly as Lohrey had projected. Cash flow problems developed, which Owens thought were due to Lohrey having underbid the Kaiser contract so that it was costing West Coast Linen more to process the laundry than the contract was bringing in. Lohrey Investments became delinquent on the Vestin loan. In August 2008, Vestin recorded a notice of default to protect its security interest in the Gilroy property. (Owens, as trustee of Owens Trust and member of the FLP, would also file a notice of default for a portion of his loan in October.)

West Coast Linen filed for chapter 11 bankruptcy that month. It was meant only as a delay tactic until Lohrey could get an automatic-debit system in place, but it had disastrous consequences. After meeting with the acting chapter 11 trustee, the trustee padlocked the gate to West Coast Linen, resulting in severe disruption to both the hotels and hospitals that relied on its laundry services. Lohrey said that as a result of the padlock, "you now have thousands and thousands of sick people in hospitals literally laying on mattresses with no sheets, no gowns...and no surgeries." This was the end of West Coast Linen. In late November 2008, its chapter 11 bankruptcy was converted to a chapter 7 bankruptcy. At that time, the company, though it could not operate, still listed $4,835,000 in assets and only $1,255,000 in liabilities.

In January 2009, the Owens Trust and Vestin each began an adversary proceeding in bankruptcy court to determine the nature and extent of their respective interests in machinery, equipment, and fixtures. Neither recovered anything by the time the bankruptcy case closed in December 2010.

By January 2009, Lohrey Investments, which had the Gilroy property as its major asset, followed West Coast Linen into bankruptcy. This bankruptcy closed in May 2012, and Owens recovered nothing.

In early in 2009, Lohrey, who had signed personal guaranties on all his loans, was forced into filing for bankruptcy. His assets totaled $2.8 million, but his liabilities exceeded $50 million. This bankruptcy proceeding also became a liquidation and led to his discharge a few months later.

On his 2008 return, Owens claimed a $9.5 million bad debt loss deduction under §166. He claimed a net operating loss (NOL) carryforward for the 2009 and 2010 tax years and amended his 2003, 2004, and 2005 tax years to claim a carryback for those years.

On audit, IRS denied the bad debt deduction and associated carrybacks and carryforwards.

Owens argued that he had been in the business of making personal loans on a continual and regular basis for years and that the loans he made to Lohrey Investments created bona fide debts which became wholly worthless in 2008 when West Coast Linen filed for bankruptcy after the trustee padlocked the building.

On the other hand, IRS contended that Owens's lending activity did not amount to a trade or business, and even if it did, the Lohrey loans were more equity than debt. Further, IRS argued that even if they were debts, they did not become worthless in the 2008 tax year.

The Tax Court found that because Owens was involved in the trade of business of lending money during the years at issue and his advances to Lohrey Investments during these years constituted bona fide debt that became worthless in 2008, he was entitled to the claimed bad-debt deduction.

The Tax Court determined that Owens lent from his personal funds continuously and regularly and did so with the purpose of making a profit. Accordingly, he was in the trade or business of lending money during the years at issue. From 1999 through 2013, he personally (alone, or acting as trustee of Owens Trust) made at least 66 loans (including the Lohrey loans) to a multitude of borrowers, easily exceeding $24 million. From 2003 through 2008-which the Court characterized as the most crucial years in this case-Owens made approximately 33 loans totaling over $21 million, including $17 million in Lohrey loans. The Court found that while Owens used the office space and employees of OFG, the family company, for the service of his personal loans, his doing so was nonetheless entirely consistent with his being in the trade or business of lending money-especially given that OFG was a lending company and employees there already knew the business.

The Court was not persuaded to the contrary by IRS's arguments that Owens: (a) failed to prove how much time he spent making personal loans (because it found that he had no need to bill specific hours on his personal lending while managing OFG); (b) did not advertise his availability to make personal loans (because he did not need to due to his well respected reputation in the lending community); and (c) subordinated his loans to a third-party lender when the borrower was under water (because it was a reasonable business decision as to a way to fully recoup his investment).

Looking to the Lantz factors, the Tax Court found that the purported loans were bona-fide debt (the Court's specific finding follows each factor below):

1. **Names.** Owens's purported loans to Lohrey Investments were evidenced by "promissory notes," showing a general intent between the parties to form a genuine debt; (Owens' favor)
2. **Maturity date**. Each promissory note included a maturity date, indicating a fixed obligation to repay (a characteristic of debt obligation), and while the maturity dates were not enforced, Owens credibly testified that he wanted to work with Lohrey and allow him time to improve his financial situation; (Owens' favor)
3. **Source of payments.** While as a practical matter, Owens's ability to be repaid might be dependent on Lohrey Investments and West Coast Linen's success (i.e., dependent on earnings being a sign of an equity investment), as a legal matter, Owens's advances were secured by a deed of trust on the Gilroy property, and Lohrey Investments was obliged to pay back the advances plus interest; (Owens' favor)
4. **Right to enforcement.** Owens had a definite right, not contingent on Lohrey Investments' success, to enforce payment on his promissory notes; (Owens' favor)
5. **Participation in management.** While the 2005 operating agreement gave Owens an option to convert his loans, or a portion of them, into equity, the Court determined that this agreement was a "workout"-the takeover of the day-to-day operations of a failed debtor to make the best of a bad deal. The Court specifically found that Owens did not receive an ownership interest in Lohrey Investments in exchange for his previous advances. By this point, it had been a year since

Owens had advanced any money to Lohrey Investments, and after he acquired his interest, he did not advance further funds until 2007, two years later; (Neutral)

6. **Status equal or inferior to other creditors.** While he did so only in an effort to recover his initial advances, Owens subordinated his advances to Vestin; (IRS's favor)
7. **Parties' intent.** Owens and Lohrey testified that a loan and not an equity investment was intended, and Owens treated Lohrey like a potential debtor from their first meeting: he reviewed Lohrey's laundry business and had appraisals drawn up for the Gilroy property and business equipment; (Owens' favor)
8. **"Thin" or adequate capitalization.** When Owens made his first loans to Lohrey Investments, they were adequately secured, and while subsequent loans might not have been, those were meant to protect Owens's initial advances. The Court did not find that they became an equity investment; (Owens' favor)
9. **Identity of interest**. Advances in proportion to the stockholder's capital interest will lead to a finding that the advance was an equity investment, but there was not sufficient evidence in the record to make a finding on this point; (Neutral)
10. **Payment of interest out of "dividends."** Owens allowed interest payments to lapse and then even continued to make additional advances, but the Court found his actions reasonable given the circumstances; (Neutral)
11. **Ability to obtain loans from outside sources.** When Lohrey initially approached OFG, he did so because other lenders considered financing Lohrey Investments too risky, yet, OFG, a legitimate lender, provided financing. Owens provided more, and later, Lohrey Investments was able to obtain still more debt financing from other sources (e.g., Vestin). (Owens' favor)

Examining all the Cooper factors, the Court found that Lohrey Investments' debt to Owens became worthless in 2008. Lohrey's laundry business had been struggling for many years. Once West Coast Linen filed for bankruptcy, and Lohrey was hung out to dry by the trustee, Owens knew Lohrey was doomed. The padlock on the door meant Lohrey was going to lose his primary clients, and his reputation, with little hope for a comeback. Lohrey even told Owens that Lohrey Investments was going to file for bankruptcy in 2008. The Court found that this showed Lohrey Investments was not going to be able to repay its debt, and in a battle over collateral, Owens was going to lose to Vestin.

IRS argued that Lohrey still believed in 2008 that Lohrey Investments' equipment and property were worth more than its liabilities. But the Court found no reason why it should give Lohrey's subjective belief at the time more merit than the facts and circumstances surrounding Owens's belief that the value of the property was "very small relative to the debt." Taking into consideration subsequent events to prove the reasonableness of Owens' belief, the Court noted that Owens indeed did not recover anything in the bankruptcies.

The Court also rejected IRS's argument that because Owens filed a proof of claim, he must have expected at least some recovery. The Court concluded that while a proof of claim may indicate that a taxpayer had some hope for recovery, it was reluctant to determine the outcome of this case based on Owens's steps to secure his place in the order of distribution.

Panagiota Pam Sotiropoulos, TC Memo 2017-75.

The Tax Court has determined that certain payments received by a U.S. citizen working abroad from a foreign taxing authority were refunds under §905(c)(1)(C)

§901(a) permits a U.S. citizen or resident to claim a credit against her Federal income tax liability for income taxes paid to a foreign country. Under §905(c)(1), if a taxpayer has claimed a credit for a foreign tax that is later "refunded in whole or in part," the taxpayer "shall notify" IRS, which is then authorized to redetermine the tax for that year and collect, upon notice and demand, any additional tax due. (§905(c)(3))

Under §905(c)(1), there are three circumstances in which the taxpayer must notify IRS and IRS will redetermine the amount of U.S. tax due:

a. If accrued foreign taxes when paid differ from the amounts claimed as credits by the taxpayer; (§905(c)(1)(A))

b. If accrued foreign taxes are not paid before the date two years after the close of the tax year to which such taxes relate; (§905(c)(1)(B)) or

c. If any foreign tax paid is refunded, in whole or in part. (§905(c)(1)(C))

Panagiota Pam Sotiropoulos (taxpayer) is a U.S. citizen who lived and worked in London, England, during 2003-2005 and at the time she petitioned the Tax Court. She was employed by the London office of Goldman Sachs during 2003-2005 and received employee compensation from which United Kingdom (U.K.) income tax was withheld. She filed both U.S. and U.K. income tax returns for each year at issue. On a timely filed U.S. return for each year, she claimed a foreign tax credit in a dollar amount equivalent to the U.K. tax withheld by Goldman Sachs.

On her U.K. tax return for each year, taxpayer claimed substantial deductions attributable to investments in U.K. film partnerships pursuant to U.K. tax provisions allowing such investors to deduct highly leveraged investment costs against their earned income. Based on these deductions, taxpayer applied for, and received, refunds on her U.K. returns of the tax that her employer had withheld and paid over to U.K. taxing authorities.

However, taxpayer took the position that these payments were not "refunds" under §905(c)(1)(C) because her entitlement to refunds remained under investigation by U.K. taxing authority. Her Majesty's Revenue and Customs (HMRC) characterized the film partnerships in which she had invested as "tax shelters." Litigation on this subject was still pending in various U.K. courts, and in the view of her tax advisers, HMRC was likely to prevail in its challenge to the deductions generated by the film partnerships. As a result, she did not file amended U.S. returns for 2003-2005 reporting reduced foreign tax credits or otherwise notify IRS pursuant to §905(c)(1).

IRS commenced an exam of taxpayer's 2003-2005 returns and, at some point before or during the audit, was informed by U.K. taxing authorities that taxpayer had invested in film partnerships, claimed substantial deductions, and filed U.K. returns requesting refunds. IRS determined that taxpayer had received U.K. income tax refunds of $413,216 in 2003, $292,663 in 2004, and $239,202 in 2005. IRS disallowed the corresponding amounts of foreign tax credits that she had claimed on her U.S. returns.

IRS sought summary judgment on the ground that the overpayments of the U.K. income tax returned to Ms. Sotiropoulos were "refunded" within the meaning of §905(c)(1)(C). She acknowledged that she received these payments, but contended that these sums had not been "refunded" because her ultimate entitlement to refunds remained under investigation in the U.K.; and so she was not required to notify IRS (by filing amended returns or otherwise) under §905(c)(1). The question the Tax Court had to decide was how these amounts should be characterized for U.S. tax purposes.

The Tax Court held that the repayments of U.K. income tax that taxpayer received during 2003-2005 represented previously paid foreign taxes that were "refunded in whole or in part" within the meaning of §905(c)(1)(C). She indisputably received repayments of tax dollars from HMRC, and she agreed that she received these repayments under a claim of right.

The Tax Court accepted as true her statements that the HMRC was challenging these repayments and that it might likely succeed in its efforts. However, it found that such was irrelevant in determining whether the repayments of U.K. tax that she received were "refunds."

The Court reasoned that for U.S. tax purposes, the term "refund" did not connote finality or the final determination of a tax liability. The Court noted that every year millions of Americans file Forms 1040 showing an overpayment and indicating the amount of the overpayment they want "refunded" to them. In the absence of concerns about identity theft or other unusual circumstances, IRS usually pays such refunds more or less automatically. Notwithstanding the payment of such refunds, IRS routinely examined such returns and, if it concluded that the taxpayer incorrectly computed the tax, it may assess additional tax after exhausting deficiency procedures. In short, the fact that a taxpayer may ultimately have to repay the money initially refunded to her does not mean that she did not get a "refund."

As a cash basis taxpayer, Ms. Sotiropoulos was entitled to claim a credit for foreign income taxes when paid. If her predictions prove correct and HMRC later collected additional 2002-2006 U.K. tax from her, she would be entitled to claim a credit for those taxes for the year in which she pays them. On the other hand, if the credits she claimed on her 2003-2005 returns were not reduced to reflect the U.K. tax that was previously refunded, she would in effect be allowed a double credit for the same tax.

The Court was not persuaded by Ms. Sotiropoulos' contention that rejection of her argument might result in "double taxation," contrary to the policies underlying the foreign tax credit and the U.S.-U.K. income tax treaty. She based this contention on the assertion that if she was required to repay refunds previously received from HMRC, and such repayments were considered creditable foreign taxes in the year of payment, her personal circumstances were such that she would obtain no U.S. tax benefit from the credits. The Court noted that Ms. Sotiropoulos offered no explanation or factual support for this vague assertion, but concluded in any event that this did not demonstrate any structural defect in the Code or give rise to "double taxation." It often happens that taxpayers, because of individual circumstances or passage of time, are unable to derive full benefit from contingent tax assets they have booked or expect to receive, such as carryforwards of foreign tax credits, net operating losses, passive losses, or investment interest. Those circumstances simply reflect the facts that the future is unpredictable and that taxable income must be determined on an annual basis.

Penley, TC Memo 2017-65.

A taxpayer's attempt to substantiate the number of hours he spent in his real estate business did not convince the Tax Court that he spent enough hours to be considered a real estate professional for purposes of the passive activity loss (PAL) rules.

In general, under the PAL rules of §469, losses from passive activities may only be used to offset passive activity income. §469(c)(1) provides that a "passive activity" is any activity which involves the conduct of any trade or business, and in which the taxpayer does not materially participate. A taxpayer is treated as materially participating in an activity if he meets at least one of the seven tests in Regulation §1.469-5T. For example, under one of these tests, an individual will be treated as materially participating in an activity for a tax year if the individual participates in the activity for more than 500 hours during such year. (Regulation §1.469-5T(a)(1))

In general, under §469(c)(2), a rental activity is per se a passive activity regardless of the taxpayer's participation in the activity. However, an individual who: (a) has at least a 10% interest in any rental real estate activity, and (b) otherwise actively participates in that activity, may offset up to $25,000 of nonpassive income with that portion of the passive activity loss, or of the deduction equivalent of the passive activity credit, attributable to that activity. The $25,000 allowance ($12,500 for marrieds filing separately) is reduced (but not below zero) by 50% of the amount by which the taxpayer's adjusted gross income (AGI) as specially computed exceeds (i) $100,000 ($50,000 for marrieds filing separately), or (ii) $200,000 ($100,000 for marrieds filing separately) for any portion of the passive activity credit that is attributable to the rehabilitation credit. (§469(i))

In addition, under §469(c)(7), the per se rule for rental activities does not apply to a qualifying real estate professional. A taxpayer qualifies as such for a particular tax year if: (1) more than half of the personal services that he performs during that year are performed in real property trades or businesses in which he materially participates; and (2) he performs more than 750 hours of services during that tax year in real property trades or businesses in which he materially participates. (§469(c)(7)(B))

In the case of a joint return, the above requirements are satisfied if, and only if, either spouse separately satisfies both requirements. Thus, the couple's activities cannot be aggregated for purposes of qualification as a real estate professional. (§469(c)(7))

Regulation §1.469-9(e)(1) states that a taxpayer who qualifies as a real estate professional can treat rental losses as nonpassive, but only if he materially participates. The regulation provides that the §469(c)(2) per se rental bar does not apply to any rental real estate activity of a taxpayer for a tax year in which the taxpayer is a qualifying taxpayer (i.e., a real estate professional). Instead, a rental real estate activity of such a qualifying taxpayer is a passive activity under §469 for the tax year unless the taxpayer materially participates in the activity.

Regulation §1.469-9(e)(3)(i) confirms that even taxpayers who establish real estate professional status must separately show material participation in rental activities (as opposed to other real estate activities) before claiming any rental losses as nonpassive.

The extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means include, but are not limited to, the identification of services performed over a period of time and of the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries. (Regulation §1.469-5T(f)(4)) This regulation does not permit a post-event "ballpark guesstimate." *(Bailey,* TC Memo. 2001-296)

During 2012, Mr. Penley was a full-time employee of HSS, Inc. (HSS). From January through September 2012, Mr. Penley worked as an entry-level field sterilization technician, and from October through December 2012 he worked as a sales account representative. Although Mr. Penley performed many of his duties from his home, he would travel to client sites as needed. These trips could take under half an hour in the case of a local client, or they could on occasion require him to travel several hours throughout Colorado. In all, Mr. Penley spent at least 2,194 hours, including occasional overtime, during 2012 performing his duties for HSS.

During 2012, Mr. Penley was also actively engaged as a Colorado licensed real estate broker, and he had an active business marketing commercial and residential properties for several clients. He also conducted a rental real estate activity through a subchapter S corporation named Harvey Herbert, Inc. (HHI), which was owned 50% each by him and his wife. During the tax years 2010 - 2012, HHI owned two single-family residential properties in Littleton, Colorado. The Penleys also held a warehouse in Sedalia, Colorado, in a self-directed individual retirement account through a limited liability company, Flying Bee Ranch, LLC. Mr. Penley spent time performing various tasks in the course of managing HHI's affairs, such as finding tenants, managing the corporation's finances, and making repairs to the properties.

Mr. Penley, acting through HHI, leased the front unit of the property in Littleton, Colorado (the Sterne property) to a tenant. During 2012, he spent significant time and effort repairing the damage to the rear unit of the Sterne property, performing substantially all of the work on the property with his wife, including installing new flooring, wiring, and plumbing.

From April through August 2012, Mr. Penley spent time performing various regulatory and due diligence activities with respect to Evergreen Park property, in Colorado Springs, Colorado, such as negotiating the purchase terms and securing financing. He acquired Evergreen Park on August 15, 2012, and thereafter made frequent trips to make improvements to the property.

Mr. Penley and his wife filed a joint income tax return for 2012, on which they reported $24,092 of total income but zero taxable income. His return included a Schedule E, Supplemental Income and Loss, which reflected a $96,354 passthrough loss from HHI in two equal parts of $48,177, one for him and his wife, as a nonpassive loss. Mr. Penley claimed that he spent approximately 2,520 hours on his real estate activities during the 2012 tax year, with approximately 1,000 of the claimed hours being related to the rehabilitation of the rear unit of the Sterne property.

On audit, IRS determined that $56,863 of HHI's reported loss for 2012 was a passive loss from real estate activities and that Mr. Penley did not qualify as a real estate professional under §469(c)(7). After making additional adjustments, IRS determined that the taxpayer's income for the 2012 tax year exceeded the phaseout threshold of §469(i) and disallowed his deduction for the passive real estate loss in full.

The Tax Court found that the taxpayer failed to demonstrate that he was a real estate professional for 2012. The Court concluded that, on the record before it, Mr. Penley had not sufficiently substantiated his claim that he spent more time during 2012 in his real estate activities than in his employment with HSS, as required by §469(c)(7)(B)(i).

Mr. Penley's primary substantiation at trial for the hours he worked during 2012 was a monthly calendar. The calendar indicated the property where he worked on a particular day and contained a brief description of the work performed, an estimate of the number of hours worked, and the number of miles driven to and from the property

The Tax Court found that the taxpayer's calendar record was untrustworthy and greatly exaggerated the time he spent on his real estate activities. Generally, Mr. Penley claimed to have worked on his real estate activities 10-14 hours on each Saturday and Sunday during 2012 and an additional 4-6 hours most weekdays, in addition to another full-time job. For Mr. Penley to have worked 2,520 hours on his real estate activities, as he claimed, he would have had to work a total 4,714 hours (i.e., 2,194 for HHS plus 2,520 on his real estate activities) in 2012. That meant that if he worked every day, he would have needed to have averaged 12.88 total hours per day (i.e., 4,712 ÷ 366 = 12.88).

Further, the Court noted that virtually all of the entries were rounded to the nearest hour or half-hour, did not specify a start or end time for the work, included the time spent driving to and from the property, and did not separate out any time for meals or other breaks. The Tax Court determined that the taxpayer's calendar did not fall within the regulation’s "any reasonable means." of substantiation. While corroborating evidence, such as credit card statements, phone bills, and emails relating to the purchase of Evergreen Park demonstrated meaningful real estate activity by the taxpayer during 2012, the Tax Court found that the taxpayer did not provide the Court with a sufficient explanation to reconcile this documentary evidence of his activities with the large blocks of time (often 4 hours to 14 hours) shown on the calendar.

Peter Phuong K. Pham, TC Summary Opinion 2016-73.

In a Summary Opinion, the Tax Court has denied "house players'" gambling losses for lack of substantiation. The taxpayers, who failed to maintain the required tax records, did not provide the Court with a basis upon which their gambling losses for the year at issue could be estimated under the Cohan rule.

If a taxpayer is engaged in the trade or business of gambling, his losses from gambling, up to the amounts of his gains from such transactions, are deductible in arriving at his adjusted gross income. (§62(a)(1), §165(d)) To be a professional gambler, the taxpayer must have engaged in gambling with the objective of making a profit. (§183(a), §183(b), §183(c)) Although a reasonable expectation of profit is not required, the taxpayer's profit objective must be actual and honest. (Regulation §1.183-2(a)) Individuals not engaged in the gambling business deduct gambling losses (to the extent of gambling gains) only as miscellaneous itemized deductions. (*Torpie,* TC Memo 2000-168)

§162(a) allows deductions for ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. An individual may be in the trade or business of being an employee. (*Primuth,* (1970) 54 TC 374) A taxpayer employee can deduct business expenses if he can prove he was not eligible for reimbursement by his employer and was not reimbursed. (*Heidt,* TC Memo 1959-31, aff'd (CA 7 1959) 4 AFTR 2d 5997) Unreimbursed employee expenses are deductible as miscellaneous itemized deductions on Schedule A, Itemized Deductions, to the extent such expenses exceed 2% of the individual's adjusted gross income. (§67(a), Regulation §1.67-1T(a)(2))

If an expense can be considered either a gambling loss under §165(d) or a business expense under §162, §165(d) as the more specific statute controls. (*Boyd v. U.S.,* (DC NV 1984) 53 AFTR 2d 84-1101, aff'd (CA 9 1985) 56 AFTR 2d 85-5266)

A taxpayer bears the burden of proving that he is entitled to the deduction claimed. In Revenue Procedure 77-29, 1977-2 CB 538, IRS suggested that gamblers regularly maintain a diary, supplemented by verifiable documentation, of gambling winnings and losses.

However, if a taxpayer establishes that a deductible expense was paid but does not establish the amount thereof, the Court can approximate the amount of the allowable deduction, "bearing heavily against the taxpayer whose inexactitude is of his or her own making," provided there is sufficient evidence in the record to provide a basis for same. *(Cohan v. Commissioner,* (CA 2 1930) 8 AFTR 10552) The Tax Court noted that it has estimated gambling losses using the test set out in Cohan in a limited situation in which the taxpayer did not provide records of gambling wins and losses but did provide evidence of his modest income and lifestyle and copies of his bank deposits and disbursements. The Court was able to estimate the taxpayer's losses on the basis of this evidence, which corroborated his testimony. (*Doffin,* TC Memo 1991-114)

Peter Phuong K. Pham and Bach T. Nguyen, husband and wife, both were employed by El Dorado Enterprises d.b.a. Hustler Casino (Hustler Casino) as house players or hosts during part of the year at issue. House players were hired by the casino to ensure that there were enough players to start and maintain card games or to gain an additional source of revenue from the player's winnings. As house players for Hustler Casino, taxpayers would start a game of "Texas Hold 'Em" poker (Texas Hold 'Em) to attract other players/customers.

The taxpayers estimated that they each played six hours per day, 21 days a month, for seven months for the year at issue. The taxpayers each received an hourly wage but were required to use their own funds for betting in the games of poker, including paying the same table fees as customers not employed by that casino. The table fees included a regular table fee of $5 per hand and a collection for a "bad beat jackpot," which was $1 per hand. Hustler Casino set aside one dollar from each hand for the bad beat jackpot. When they won, they would receive chips from Hustler Casino which they either used for further gambling or cashed in.

Taxpayers received a Form W-2G, Certain Gambling Winnings, for $16,800 in winnings from Hustler Casino. They did not report the $16,800 on their Form 1040 because they contended that their gambling losses as house players at Hustler Casino exceeded their gambling winnings. They claimed that they incurred $14,000 in Texas Hold 'Em poker gambling losses for the year at issue on the basis of their estimate that they each lost $1,000 per month over a 7-month period. They did not provide any documentation or other proof to support their estimated losses. The taxpayers also asserted that they incurred $7,056 in gambling losses, estimated from the $1-per-hand fees for the bad beat jackpot and the number of hours they worked.

The taxpayers did not provide any evidence of their losses. They asserted that initially they tried to keep track of their poker winnings and losses by writing down the amount won or lost at the end of each day, but after a while they gave up that practice because it was "bad for your psyche...you need to be strong mentally" when playing cards.

The Tax Court denied the taxpayers' deductions for gambling losses, rejecting their contention that it was too difficult to maintain contemporaneous records of their gambling activities as without merit.

The taxpayers did not provide evidence of their losses, such as a personal log of daily winnings and losses, win/loss statements, or bank records. Although they had a modest income for the year at issue, they did not provide testimony or other evidence at trial to corroborate the claimed losses.

When a taxpayer establishes that he paid or incurred a deductible expense but fails to establish the amount of the expense, the Court may estimate the amount allowable in some circumstances under Cohan. But in order for the Court to estimate the amount of the expense, it must have some basis upon which an estimate can be made. Here, the taxpayers failed to provide the Court with a basis upon which their gambling losses for the year at issue could be estimated.

Phillips, TC Memo 2017-61.

Shareholder's guarantee of a loan to her S corporation did not give her basis in the entity even where the lenders sued her on her guarantee and recovered deficiency judgments against her, resulting in liens against her real and personal property. As a result, she could not deduct her distributive share of the entity's losses.

Deductions and losses of an S corporation are passed through to shareholders and (except as otherwise limited by the Code) claimed on their own returns. However, a shareholder may deduct his pro rata share of these passed-through items only to the extent of the sum of his adjusted basis in the S corporation stock-determined by taking into account the increases in basis for his share of the S corporation income during the year and the decreases in basis for nondividend distributions for the year (§1366(d)(1)(A) -plus his adjusted basis in any indebtedness of the S corporation to him. (§1366(d)(1)(B), Regulation §1.1366-2)

Under regulations that generally apply to transactions on or after July 23, 2014, an S corporation shareholder who merely acts as a guarantor or in a similar capacity (e.g., surety or accommodation party) has not created basis of indebtedness unless the shareholder actually makes a payment, and then only to the extent of such payment. (Regulation §1.1366-2(a)(2)(ii))

For transactions before July 23, 2014, the courts generally held that merely guaranteeing an S corporation's debt was not enough to generate a basis under §1366(d)(1)(B). To increase his basis in an S corporation, a shareholder had to make an "actual economic outlay."

In *Selfe v. U.S.,* (CA 11 1985) 57 AFTR 2d 86-464, the Eleventh Circuit agreed that an economic outlay was required before a stockholder may increase her basis. But it did not believe that this test necessitated that the shareholder "must, in all cases, absolve a corporation's debt before she may recognize an increased basis as a guarantor." Rather, it concluded that a basis increase may be justified "where the facts demonstrate that, in substance, the shareholder has borrowed funds and subsequently advanced them to her corporation." Establishment of this factual predicate would require proof that "the lender looks to the shareholder as the primary obligor." The Court recognized that in practice this argument would usually meet with little success because the taxpayer would be unable to demonstrate that the substance of her transaction was different than its form.

In *Sleiman v. Commissioner,* (CA 11 1999) 84 AFTR 2d 99-5987), the Eleventh Circuit distinguished *Selfe* and held that a guaranty without payment did not create basis. In that case, the shareholder-guarantors had not previously been obligors on any S corporation loan and they pledged no collateral in support of their guaranties. Rather, the collateral was supplied by the S corporation, which was successful and well established. At the time they extended credit, the banks estimated that the collateral (chiefly real estate) was worth nearly twice the amount of the loans. A bank officer testified that the bank had requested guaranties from the taxpayers, not because it looked to them as the primary source for repayment, but because the bank's general policy was to require personal guarantees on loans to closely held corporations. The Court concluded that the taxpayers had not established the unusual factual predicate in *Selfe* necessary to show that the loans, in form extended to the S corporation, had in substance been extended to the shareholders individually.

S corporation, Olson & Associates (Olson), which was owned 50% by Carl Olson, Jr., and 50% by Sandra Phillips, was engaged in developing and selling residential and commercial real estate. Like many such businesses, it relied heavily on debt financing. The only collateral to which the banks could look for repayment of their loans was the real estate and other assets held by Olson and its subsidiaries. Virtually all of the loans that the banks extended to Olson and its subsidiaries were guaranteed by Olson's two shareholders and/or their spouses.

The nationwide downturn in the real estate market that began in late 2006 was especially severe in Olson's region of operations. Starting in 2007, the company's business experienced a spiraling decline in sales, revenue, and cash flow from which it never recovered. This precipitated a default on virtually every loan owed by the company. The lenders sued for repayment, typically foreclosing on the property that secured the indebtedness. Because the real estate had declined so precipitously in value, the collateral was usually insufficient to satisfy these judgments.

The lenders also sued the guarantors, seeking enforcement of the personal guaranties to satisfy the deficiencies. Ten of these actions resulted during 2008 - 2009 in final judgments gating about $105 million against Mrs. Phillips and the coguarantors, including her husband.

The coguarantors bore joint and several liability for each of these judgments. As of the time the record in this case closed, neither Mrs. Phillips nor her husband had paid any amount toward these judgments. Nor had either made any direct payments to Olson's lenders under his or her guaranties.

After receiving professional advice in 2010, including a formal opinion from tax counsel, Mrs. Phillips took the position that she was entitled to increase her basis in her Olson stock as a result of these judgments. She assigned $7,069,639 of the unpaid judgments to 2008 and the remaining $97,703,385 to 2009. For each year, she then allocated to each coguarantor a pro rata share of the unpaid judgment amounts exceeding all available collateral. After allocating her "proportionate share of the judgments less the fair market value (FMV) of the underlying property securing the liabilities," she claimed that she had made deemed capital contributions to Olson, and so secured additional basis in her stock, of $1,553,360 in 2008 and $30,187,249 in 2009, allowing her to claim loss deductions.

On audit, IRS determined that for the years at issue Mrs. Phillips was not entitled to any basis increase on account of her loan guaranties or the unpaid judgments against her.

The Tax Court held Mrs. Phillips did not have enough basis in Olson to support the losses she claimed.

Although Mrs. Phillip claimed an increased basis in her Olson stock on her return, at trial she argued alternatively for additional basis in the company's indebtedness to her. As the Tax Court noted, both arguments rested on a "substance vs. form" argument-on the theory that the guaranteeing shareholder had in substance borrowed funds directly from the lender, then transferred the loan proceeds to the S corporation either as a contribution to capital or a back-to-back loan. In either case, the question was whether Mrs. Phillips made the actual economic outlay requisite to securing a basis increase.

The Court concluded that the taxpayer's situation resembled *Sleiman* more than it did *Selfe*. The facts here differed from those in *Selfe* on each of the important points identified by the Eleventh Circuit. There was no evidence that Olson's lenders had a prior relationship with the taxpayer or that the taxpayer previously had been obligor on these loans. Mrs. Phillips did not pledge any of her personal assets as collateral for the loans; all the collateral (consisting primarily of real estate) was supplied by Olson (through its special purpose entities or their subsidiaries). Olson was a well-established company with a good reputation, and the taxpayer conceded that the loans when made were clearly supported by the collateral that was pledged. Most importantly perhaps, the taxpayer produced no testimony or other evidence from any of the lending banks that any bank looked to the shareholder as the primary obligor on any loan; the Tax Court noted that it was hard to see how a taxpayer could establish a bank's intentions or expectations on this point without producing testimony from someone at the bank.

While Mrs. Phillips argued that the deficiency judgments against her gave rise to an "actual economic outlay" by (among other things) impairing her credit, the theory underlying *Selfe*-on which she relied-was that the bank, while nominally lending to the S corporation, may in substance have lent to the shareholder, who then contributed the loan proceeds to the corporation. In order to identify the "true obligor" in such circumstances, it was necessary to examine the lender's intentions and other economic facts existing when the lender made the loan. A court's entry of a deficiency judgment against a guarantor many years later, after the corporation had defaulted and the corporation's collateral had proven insufficient, was simply not relevant in determining whether the lender, when initially extending credit, looked to the shareholder as the primary source of repayment.

The Tax Court concluded that Mrs. Phillips could make the required "economic outlay" in favor of Olson only by making a payment toward the judgments. This would create a debt from Olson to her and give her additional basis in that amount. But since she had made no payments either on the guaranties or on the judgments, she was not entitled to the basis increases that she claimed.

In addition, the Tax Court found that even if the taxpayer had shown that the deficiency judgments theoretically entitled her to some basis adjustment, she did not carry her burden of proving the size of the basis increase. Mrs. Phillips' allocation of the unpaid deficiency judgments entered against her and the coguarantors rested on questionable assumptions that she neither addressed nor answered. Her estimates of the FMV of the collateral transferred to the judgment creditors were inadequately supported and internally inconsistent; there were unresolved questions as to whether certain collateral was returned and whether the taxpayer made associated downward adjustments to her claimed increase in basis. Further, for each loan in question, all coguarantors bore joint and several liability. Mrs. Phillips advanced no reason for believing that the judgment creditors would pursue all coguarantors pro rata rather than simply targeting the ones with the deepest pockets; allocating a pro rata portion of that judgment to Mrs. Phillips could possibly generate a combined basis increase exceeding the amount owed to the judgment creditors in the first place.

Powers, TC Memo 2017-179

Taxpayer did not exercise nonqualified stock options in the year that IRS contended. Accordingly, the taxpayer did not have unreported income in that year from the exercise of those options.

An employee who receives nonqualified stock options as compensation for services performed realizes ordinary income. (§83(a)) However, if the options lack a readily ascertainable fair market value (FMV) at grant, the employee does not immediately recognize income. (§83(e)(3)) Instead, the employee recognizes income upon exercising the option. (Regulation §1.83-7(a)) When an employee exercises nonqualified stock options, the employee must include in gross income the difference between the option stock's FMV at exercise and the amount paid to acquire the option stock. (§83(a)(1))

In 2003, Mr. James Powers and comScore negotiated and signed an employment termination agreement which included comScore's granting him nonqualified stock options to acquire 100,000 shares of comScore stock for 25 cents per share. At the time the options were granted, they did not have a readily ascertainable FMV.

In 2007, in anticipation of comScore's public offering, Mr. Powers' stock options were subject to a 1:5 reverse split, which resulted in his holding options to acquire 20,000 shares of comScore stock for $1.25 per share.

For 2007, comScore issued to Mr. Powers a Form W-2 (Wage and Tax Statement) reporting that he had received $131,000 of “Wages, tips, other compensation”

The CPA who prepared Mr. Powers' 2017 return, Mr. Beatson, asked Mr. Powers about the circumstances surrounding comScore's issuance of the Form W-2. Mr. Powers informed Mr. Beatson that the Form W-2 reported his exercise of 4,000 comScore options and that he paid $5,000 to exercise the options.

Mr. Powers filed his 2007 return, reporting $257,467 in wages. Of this amount, $126,000 was attributable to the exercise of 4,000 comScore options (determined by taking the $131,000 in wages reported on the Form W-2, and subtracting the $5,000 paid to exercise the 4,000 comScore options). In addition to the taxpayer's return, Mr. Beatson prepared a Form 8919 (Uncollected Social Security and Medicare Tax on Wages), which the taxpayer filed with his return. On the Form 8919, Mr. Beatson stated that the $131,000 in wages comScore reported on the Form W-2 was incorrect because Mr. Powers had $5,000 of unreimbursed employee expenses in 2007. The taxpayer also stated that comScore failed to withhold Social Security and Medicare taxes from Mr. Powers' wages.

For 2008, comScore issued Mr. Powers a Form 1099-MISC (Miscellaneous Income), reporting that he had received $250,104 of nonemployee compensation from the exercise of 14,000 options. Mr. Powers contended that the $250,104 from the exercise of the 14,000 comScore options in 2008 represented the only income from the exercise of comScore options during 2008.

On audit, IRS determined that Mr. James received unreported income from the exercise of 18,000 comScore options in 2008 and issued a notice of deficiency for the 2008 and 2009 tax years. The taxpayer sought relief in the Tax Court.

The Court determined that the issue was whether Mr. Powers exercised 4,000 options in December 2007, as he contended, or on January 17, 2008 (with the result that he had unreported income in 2008), as IRS argued. There was no dispute that the comScore options were nonqualified stock options and did not have a readily ascertainable FMV at the time the options were granted. The parties agreed that Mr. Powers exercised 14,000 options between March and December 2008 but disagreed as to whether Mr. Powers exercised an additional 4,000 options in 2008. Accordingly, the question of whether the taxpayer received unreported income in 2008 from the exercise of the 4,000 options in dispute depended on whether Mr. Powers exercised the options in 2007 or in 2008.
The Tax Court concluded that Mr. Powers did not exercise the 4,000 options in dispute in 2008. Accordingly, he did not receive unreported income in 2008 from the exercise of those options. Although neither Mr. Powers nor comScore had any records relating to Mr. Powers' exercise of the options in dispute in 2007, Mr. Powers had demonstrated that he exercised these options in 2007.

In an email dated April 14, 2008 to Mr. Beatson, Mr. Powers explained that he had exercised the 4,000 options in 2007. Mr. Powers sent the email in response to Mr. Beatson's request for information about the Form W-2 reporting that Mr. Powers had received $131,000 in wages. Mr. Powers explained that the wages reported on the Form W-2 were derived from his exercise of the options in dispute and that he paid $5,000 to exercise the options. The explanation on the Form 8919 that Mr. Powers filed with his 2007 return was consistent. Although Mr. Beatson explained on the Form 8919 that the Form W-2 was incorrect because he had $5,000 of unreimbursed employee expenses, Mr. Beatson credibly testified at trial that he reduced the $131,000 in wages by $5,000 on the basis of the information provided by Mr. Powers regarding his exercise of the options in dispute.

The taxpayer's version of events was also supported by the “Taxes Due and Paid Report” (report) prepared by comScore. The report covered Mr. Powers' exercise of comScore options from January 1 through December 31, 2008. Mr. Beatson testified that comScore prepared the report in response to a telephone call Mr. Powers made to comScore while Mr. Beatson and Ms. Roland, the IRS revenue agent assigned to the taxpayer's returns, were present. The report showed that Mr. Powers exercised 14,000 comScore options between March and December 2008 and received $250,104 of income therefrom. More importantly, the report was consistent with the Form 1099-MISC comScore issued to Mr. Powers and filed with IRS. There was nothing in the report indicating that Mr. Powers exercised additional comScore options in January 2008.

At trial, Mr. Powers introduced a summary sheet created by Ms. Roland that covered Mr. Powers' exercise of comScore options in 2008. Ms. Roland used the report that comScore prepared to reconcile her summary sheet. The transactions on the summary sheet and the report are identical except that Ms. Roland's summary sheet also showed that Mr. Powers exercised 4,000 options in January. The summary sheet showed that Mr. Powers exercised the 4,000 options between January 7 and 8, 2008, which contradicts IRS's contention on brief that the options in dispute were exercised on January 17, 2008. Further, Ms. Roland incorrectly calculated the income that IRS alleges Mr. Powers received from exercising the options in dispute in January 2008. Under §83(a), income from the exercise of nonqualified stock options without a readily ascertainable FMV at the time of the grant is equal to the FMV of the stock less the exercise price. Ms. Roland determined Mr. Powers' income from the alleged exercise was the price at which Mr. Powers' brokerage statements showed that he sold 4,000 comScore shares between January 7 and 8, 2008, less the exercise price.

IRS's primary piece of evidence in support of its position was Mr. Powers' Morgan Stanley Smith Barney account statement for the period January 2008, which showed that on January 17, 2008, 4,000 shares of comScore stock were deposited into Mr. Powers' brokerage account. However, the statement did not show that he exercised 4,000 comScore options on that date. There was no evidence that any options were exercised on January 17, 2008.

Mr. Powers' brokerage statements also showed that he sold 4,000 comScore shares between January 7 and 8, 2008. On brief, IRS agreed with this but failed to explain when Mr. Powers exercised the options to acquire these 4,000 shares. Presumably, these shares had to be acquired before being sold. At trial, IRS asked Mr. Powers whether the 4,000 comScore shares he sold between January 7 and 8, 2008, were purchased by him on the open market, and he testified they were not. The Court noted that there was nothing in the record to show that Mr. Powers had any comScore holdings except for the options he received in the 2003 termination agreement.

Mr. Powers testified that the 4,000 shares sold between January 7 and 8, 2008, were derived from the December 2007 exercise of the 4,000 options in dispute. The Court found that Mr. Powers' testimony was completely consistent with a December 2007 exercise of the 4,000 options in dispute and a subsequent January 7 and 8, 2008, sale of the 4,000 shares derived from these options. There was a multitude of possible reasons why the shares obtained by the exercise of options in December 2007 were not sold until January 2008, but there was no evidence of a January 2008 exercise of options.

QinetiQ U.S. Holdings Inc., (CA 4 1/6/2017) 119 AFTR 2d ¶ 2017-312.

The Court of Appeals for the Fourth Circuit has held that IRS notices of deficiency are not subject to the Supreme Court's holding that the Administrative Procedure Act (APA) requires federal agencies to provide a "reasoned explanation" for agency final decisions. The Circuit Court also affirmed the Tax Court's holding that, where a corporation issued 49.75% of its stock to an employee shortly after the formation of the corporation, the stock was never subject to a substantial risk of forfeiture.

Under the APA, agency action made reviewable by statute, and final agency action for which there is no other adequate remedy in a court, are subject to judicial review. (5 USC 704) The APA requires courts to "hold unlawful and set aside agency action, findings, and conclusions" that are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law" or "unsupported by substantial evidence." (5 USC 706(2)(A), 5 USC 706(2)(E))

The APA authorizes district courts to review agency actions with a "focal point" on the "administrative record already in existence." *(Camp v. Pitts*, (S Ct 1973) 411 U.S. 138) The Supreme Court has held that a required component of this administrative record is a "reasoned explanation for [the agency] action." (*FCC v. Fox Television Stations, Inc.*, (S Ct 2009) 556 U.S. 502)

A statutory notice of deficiency tells a taxpayer that IRS has determined a deficiency and must describe the basis for and identify the amounts (if any) of tax, interest, additional amounts, additions to tax and assessable penalties. (§7522(a))

§83(a) generally treats property transferred in connection with the performance of services as gross income of the person who performed such services.

This rule is modified, however, when property transferred in connection with the performance of services is subject to a substantial risk of forfeiture. Property transferred under such circumstances is not treated as gross income of the individual providing services until the first tax year in which the property was no longer subject to a substantial risk of forfeiture. (§83(a))

Property is not "subject to a substantial risk of forfeiture to the extent that the employer is required to pay the fair market value of such property to the employee upon the return of such property." (Regulation §1.83-3(c)(1)) In addition, property is not subject to a substantial risk of forfeiture if "at the time of the transfer, the facts and circumstances demonstrate that the forfeiture condition is unlikely to be enforced." (Regulation §1.83-3(c)(1), Regulation §1.83-3(c)(3)) Likewise, conditions imposed at the time of transfer that require the return of property "if the employee is discharged for cause or for committing a crime," or "if the employee accepts a job with a competing firm," will not be sufficient to constitute a substantial risk of forfeiture. (Regulation §1.83-3(c)(2))

Mr. Hume formed TGH, an S corporation that provided government contracting services. He then engaged in discussions with Mr. Chin about joining the business enterprise. They agreed and formed DTRI, another S corporation, to perform the same contracting services. On December 9, 2002, Hume received Class A voting stock for $450 and became DTRI's president. On that day, Chin received Class A stock for $445 and Class B nonvoting stock for $5 (collectively, the Chin stock) and became the vice president and Chief Operating Officer (COO).

Shortly thereafter, Hume and Chin each entered into a Shareholder Agreement which contained provisions for restricting the sale or transfer of stock and for returning stock to the corporation in the event of either Hume's or Chin's death, disability, or termination of employment with DTRI. The Shareholders Agreement contained provisions for calculating the "Agreement Value" of the shares upon the occurrence of any of these events, and gave the corporation the option of repurchasing Hume's or Chin's shares at the calculated value in the event of such death, disability, or termination without cause. Additionally, in the event of voluntary resignation by the employee, the Shareholders Agreement provided DTRI the option of purchasing the shares at 5% of the Agreement Value for every year of the departing employee's employment, up to a maximum of 100% after twenty years. However, in the event that the employee voluntarily resigned and engaged in competition with DTRI, or that DTRI terminated the employee for cause, the corporation would have the option to purchase the shares at 5% of the Agreement Value for every year of employment, up to a maximum of 25% of the Agreement Value.

In the years from 2002 through 2008, DTRI, Chin and Hume made representations, in various ways, that Chin was a shareholder of DTRI. And, Chin showed DTRI income, in proportion to the number of his shares, on his Forms 1040 for those years.

Until 2008, DTRI took no deduction with respect to the Chin stock, and Chin reported no income with respect to the stock. In 2008, the taxpayer, QinetiQ, purchased all the stock of DTRI, and all of the previous shareholders received cash for their DTRI stock. QinetiQ then considered the Chin stock to no longer be subject to a substantial risk of forfeiture and deducted the 2008 value of the stock as a compensation expense.

IRS transmitted to QinetiQ a notice of deficiency stating that it had determined that QinetiQ had not established that it was entitled to a deduction under the provisions of §83, and that QinetiQ's taxable income for the year thereby was increased by $117,777,501. IRS did not give a further explanation of its decision in its notice of deficiency.

The Tax Court held in favor of IRS and denied the deduction. (*QinetiQ U.S. Holdings Inc.,* TC Memo 2015-123

The reasoned explanation rule does not apply to notices of deficiency. The Fourth Circuit held that the Supreme Court's reasoned explanation rule does not apply to IRS notices of deficiency.

QinetiQ argued that the requirement of a reasoned explanation necessarily applies to a notice of deficiency because that notice is a final agency action within the meaning of the APA. Thus, according to QinetiQ, failure by IRS to comply with this APA requirement rendered the notice of deficiency invalid.

The Court disagreed with this argument, which it said fails to consider the unique system of judicial review provided by the Code for adjudication of the merits of a notice of deficiency. It is that specific body of law, rather than the more general provisions for judicial review authorized by the APA, that governs the content requirements of a notice of deficiency.

Under the APA, a reviewing court may not conduct a de novo evaluation of the record regarding the subject matter before the agency. (*Fla. Power & Light Co. v. Lorion,* (S Ct 1985) 470 U.S. 729) Some agency-specific statutes, however, provide materially different procedures for judicial review that predate the APA's enactment. One such example is the Code, which authorizes de novo review in the Tax Court of a notice of deficiency. (§6214) Because the Code's provisions for de novo review in the Tax Court permit consideration of new evidence and new issues not presented at the agency level, those provisions are incompatible with the limited judicial review of final agency actions allowed under the APA.

Additionally, the Court observed that, for an agency action to be deemed "final" within the meaning of the APA and, thus, subject to the APA's requirement of a reasoned explanation, the agency "action must be one by which rights or obligations have been determined, or from which legal consequences will flow." "Legal consequences" include agency determinations that restrict the government's power to take contrary litigation positions in subsequent proceedings.

After issuing a notice of deficiency, however, IRS may later assert in the Tax Court new legal theories and allege additional deficiencies. (§6214(a); Tax Court Rule 142(a)(1)) Likewise, a taxpayer may raise new matters before the Tax Court not previously considered during the administrative process. (§6214(a)) In contrast to these fluid procedures, the APA's "arbitrary" and "capricious" standard requires that judicial review of an agency action be confined to the static administrative record with deference accorded to the agency's decision, and that the agency action be final in all respects before judicial review commences. See 5 USC 704, 5 USC 706(2)(A).

Given these significant variations in the scope of judicial review under the two statutory schemes, the Court concluded that the APA's general procedures for judicial review, including the requirement of a reasoned explanation in a final agency decision, were not intended by Congress to be superimposed on the Code's specific procedures for de novo judicial review of the merits of a notice of deficiency.

The Court held that the content of the notice was sufficient to satisfy the requirements of the Code.

The Court first noted that §7522(a) provides that "an inadequate description under the preceding sentence shall not invalidate such notice." However, it said, the statute is silent regarding the circumstances, if any, that will cause a notice of deficiency to be invalidated.

Some federal courts of appeal have held that a notice of deficiency may be invalidated for the failure to include certain information. For example, the Fourth Circuit held that a notice of deficiency must contain a statement that IRS has examined a return and has determined a deficiency in an "exact amount." *(Abrams,* (CA 4 1986) 57 AFTR 2d 86-1130) And the Ninth Circuit "implicitly" endorsed application of a rule that major errors in a notice of deficiency causing prejudice to a taxpayer will render that determination invalid. (*Elings,* (CA 9 2003) 91 AFTR 2d 2003-1648) In contrast, some circuits have held that minor, nonprejudicial flaws in a notice of deficiency will not cause such notice to be invalidated. (*Elings;Smith,* (CA 10 2001) 88 AFTR 2d 2001-7315)

In this case, the notice of deficiency informed QinetiQ that IRS had determined a deficiency in an exact amount for a particular tax year and incorporated by reference an enclosed statement that "the deduction you claimed for Salaries and Wages in the amount of $117,777,501 under the provision of §83 is disallowed in full as you have not established that you are entitled to such a deduction." The notice of deficiency further informed QinetiQ that it had the right to contest this deficiency determination in the Tax Court. The Court said that it discerned no prejudice to QinetiQ due to the absence of additional information in the notice of deficiency.

The Court, affirming the Tax Court, held that QinetiQ failed the substantial risk of forfeiture test, and therefore it denied QinetiQ the compensation deduction.

The Court said, in interpreting §83(a), that an employer seeking to establish entitlement to a deduction for property transferred to an employee in a prior tax year must show that the property was "subject to a substantial risk of forfeiture" from the time the property was transferred until the tax year for which the deduction is claimed. The Court concluded that QinetiQ failed that test.

Here, the terms of the Shareholders Agreement contained certain conditions that would require Chin to return the stock to DTRI. In the event of Chin's death, disability, or termination without cause, the Shareholders Agreement provided a formula for DTRI to repurchase Chin's stock that corresponded with 100% of the Agreement Value. Given this requirement of fair market value, the repurchase of Chin's stock under those circumstances would not be considered a "forfeiture" within the meaning of Regulation §1.83-3(c)(1).

In the event of Chin's voluntary resignation, the Shareholders Agreement would have provided for DTRI to repurchase the stock at 5% of the Agreement Value for every full year of service by Chin, up to the full value after 20 years of service. However, if Chin were terminated for cause or voluntarily resigned and engaged in competition with DTRI, the stock repurchase price would be 5% of the Agreement Value for each year of service, up to a maximum of 25% of the Agreement Value.

Read together, these additional provisions of the Shareholders Agreement indicate that the only circumstances in which Chin would be required to forfeit his stock at a below-market price would be if Chin voluntarily resigned before 20 years of employment, if Chin voluntarily resigned and entered into competition with DTRI, or if Chin were terminated for cause. Because Regulation §1.83-3(c)(2) provides that forfeiture provisions triggered by termination for cause or by engaging in Competition do not constitute a substantial risk of forfeiture, the only remaining ground for forfeiture would be the circumstance of Chin's voluntary resignation.

The Tax Court had concluded that the likelihood of forfeiture due to Chin's voluntary resignation did not amount to a "substantial risk." It made a factual determination that Hume would have been unlikely to enforce the shareholder restrictions on the stock in the event of Chin's voluntary departure. In concluding that Chin's stock was not subject to a substantial risk of forfeiture but was intended to be treated as "fully vested and outstanding stock" without restrictions, the Tax Court cited Chin's role as an initial investor in DTRI, Chin's "very close work relationship" with Hume, and Chin's "vital role within DTRI as the executive vice president, COO, and a 49.75% shareholder in voting stock."

The Fourth Circuit Court of Appeals agreed with the Tax Court’s conclusions.

Quintal, TC Summary Opinion 2017-3.

Where, in a badly drafted separation agreement, two clauses regarding payments from the husband to the wife conflicted with each other, the clause that disqualified the payments from being considered alimony was more definitive and thus prevailed, with the result that the husband got no alimony deduction.

Generally, property settlements (or transfers of property between spouses) incident to a divorce do not give rise to deductions or recognizable income. (§1041) On the other hand, amounts received as alimony or separate maintenance payments are included in gross income and taxable to the recipient (§71(a)) and deductible by the payor in the year paid. (§215(a))

An alimony or separate maintenance payment is one that meets the following four requirements:

a. The payment must be made under a "divorce or separation instrument";

b. The instrument must not designate the payment as not includable in the recipient spouse's gross income under §71 and not deductible by the payor spouse under §215;

c. The payor and payee spouses must not be members of the same household at the time the payments are made; and

d. The payor's obligation to make the payment must end at the death of the payee spouse. (§71(b)(1))

Mr. and Mrs. Quintal entered into a separation agreement that contained several exhibits. Before the separation agreement was executed, they engaged in last-minute negotiations, and several of the exhibits were substantially revised. In some instances, entire paragraphs of an exhibit were lined through and replaced with handwritten statements.

Exhibit B, originally titled "Alimony," was revised to read "Unallocated Support." Exhibit B stated in part that Husband would pay to Wife $900 per week, followed by "(See Exhibit J)," and that "any alimony payments shall terminate" upon the earlier of the death of Husband or Wife or the latter's remarriage. Exhibit B further stated that the parties "acknowledge that Husband anticipates that the above payment is deductible to him and includable to Wife."

Exhibit J was titled "Custody, Support, Visitation." Although Exhibit J originally referred to Husband's obligation to make child support payments, that statement was lined through and was replaced with the phrase "See Exhibit B..." It also provided "[i]n accordance with §71(b)(1)(B), the Husband and Wife expressly agree to designate and hereby do designate all payments required in this Exhibit as excludable and non-deductible payments for purposes of §71 and §215, respectively.

Husband deducted the $900 weekly payments as alimony; IRS disallowed his deduction in full.

The Court agreed with IRS that, as a result of the Exhibit J language that provided that the payments were not deductible, the payments did not meet the requirement in §71(b)(1)(B) and thus were not alimony.

Husband relied on Exhibit B, which expressly provided for "unallocated support" payments, as opposed to alimony or child support payments. Noting that Exhibit J did not expressly require any form of payment, Husband argued that the statement in Exhibit J that IRS relied upon was not relevant to the question of whether the payments constituted alimony. Husband further asserted that the parties' last-minute negotiations and revisions to the separation agreement were intended to ensure that the disputed payments would be treated as alimony for purposes of §71 and §215.

The Court said that, as an initial matter, it rejected Husband's contention that it should evaluate his and Wife's intent regarding the characterization of the disputed payments. Citing *Okerson,* (2004) 123 TC 258, it said that "Congress eliminated any consideration of intent in determining the deductibility of a payment as alimony in favor of a more straightforward, objective test that rests entirely on the fulfillment of explicit requirements set forth in §71."

The Court acknowledged, as Husband contended, that Exhibit J did not expressly require any payment or otherwise fix an amount to be paid as alimony or child support. Husband's narrow focus on this aspect of Exhibit J, however, gave no effect to the cross-references in Exhibits B and J. The proper consideration of the separation agreement required a construction of the document as a whole, including the exhibits and the cross-references within the exhibits.

Reading the separation agreement as a whole, Exhibits B and J must be read in tandem, and the unallocated support payments prescribed in Exhibit B were subject to the provisions of both that exhibit and Exhibit J. In this regard, the handwritten revisions to the settlement agreement were poorly conceived. Although Exhibit B was revised to state that the parties "acknowledge that husband anticipates that the unallocated support payment is deductible to him and includable to Wife," the Court held that Exhibit J was a more definitive statement and thus controlled in this case.

Because the settlement agreement provided that the unallocated support payments were excludable from income and not allowable as deductions, the payments did not satisfy the definition of alimony under §71(b)(1)(B).

Qunell, TC Summary Opinion 2016-86.

An individual who worked as an atmospheric manager in Afghanistan, in connection with a contract that it held with the U.S. Department of Defense (DOD), had his abode in the U.S. and therefore did not qualify for the §911 foreign earned income exclusion.

§911(a) provides that a qualified individual may elect to exclude from gross income, subject to limitations set out in §911(b)(2), his foreign earned income. To be entitled to this exclusion, a taxpayer must satisfy two requirements, one of which is that he must be an individual "whose tax home is in a foreign country." (§911(d)(1))

§911(d)(3) provides that the term "tax home" means in the case of an individual, "such individual's home for purposes of section 162(a)(2)." Under §162(a)(2), a person's home is generally considered to be the location of his regular or principal place of business. (*Mitchell,* (1980) 74 TC 578)

However, §911(d)(3) also provides that "[an] individual shall not be treated as having a tax home in a foreign country for any period for which his abode is within the U.S." That is, an individual whose "abode" is within the U.S. cannot establish that his "tax home" is in a foreign country. (*Jones,* (CA 5 1991) 67 AFTR 2d 91-795, *Harrington,* (1989) 93 TC 297)

After 17 years of active service in the U.S. Army, Timothy Qunell began working for AECOM Technology (AECOM) as an atmospheric manager in Afghanistan on July 7, 2010, in connection with a contract that AECOM held with the DOD. His employment with AECOM lasted approximately one year and four months.

During that time Mr. Qunell lived on a U.S. military facility in Kabul, Afghanistan. His passport records show that during 2011 he left Afghanistan from time to time for vacations. Early in 2011, he traveled to the U.S. He was married on February 14 of that year and returned to Afghanistan without his wife a short time later.

During 2011, Mr. Qunell and his wife owned a house in Illinois (Illinois residence). His wife and their children lived in the Illinois residence while he was working in Afghanistan. Neither his wife nor any of their children visited him while he was in Afghanistan. In addition, Mr. Qunell maintained several bank accounts, all at banks in the U.S.

On November 18, 2011, Mr. Qunell resigned on account of a disagreement with AECOM as to the location of his next assignment. He wanted and believed he was entitled to an assignment in the U.S., but he felt that AECOM was delaying such an assignment and was keeping him in Afghanistan. Mr. Qunell was unemployed from the time he left his employment with AECOM until he returned to the U.S. Army in July of 2012.

Mr. Qunell's 2011 Federal income tax return, due on April 15, 2012, was filed on November 5, 2013, after he was notified that IRS was preparing a 2011 substitute return. His return included a Form 2555 (Foreign Earned Income) on which he disclosed the wages he earned from AECOM while employed in Afghanistan but took the position based on §911(a) that his tax home was in Afghanistan and excluded those wages from the income otherwise reported on that return.

The Tax Court concluded that Mr. Qunell's abode was in the U.S., and so he did not qualify for the foreign earned income exclusion.

The Court reasoned that the term "abode" means one's home, habitation, residence, domicile, or place of dwelling, and it does not mean one's principal place of business. Thus, "abode" has a domestic rather than vocational meaning, and stands in contrast to "tax home" as defined for purposes of §162(a)(2). A taxpayer's "abode" is generally in the country in which he has the strongest economic, family, and personal ties. (*Bujol,* TC Memo 1987-230) A taxpayer posted abroad will invariably have some connections with the foreign country in which he works, but if his ties to the U.S. are stronger, his abode remains in the U.S. (*Harrington,* (1989) 93 TC 297)

The Tax Court was satisfied that Mr. Qunell's economic, family, and personal ties to the U.S. were sufficiently strong for the Court to consider the U.S. to be the location of his abode at all relevant times. Accordingly, the wages he earned in Afghanistan during 2011 were not excludable from his income under §911(a).

The Court reasoned that during 2011 Mr. Qunell owned a home in Illinois where his wife and children lived and he maintained bank accounts in the U.S. He lived on a military facility in Kabul, Afghanistan, his family did not visit him there, and nothing in the record suggested that he traveled within Afghanistan other than as required by his employment. Further, Mr. Qunell terminated his employment with AECOM because he wanted to return to the U.S. His ties to Afghanistan were entirely transitory and did not extend much beyond, if at all, the bare minimum required to perform his duties there. Other than the location of his employment, Mr. Qunell did not established that he had any economic, family, or personal ties to Afghanistan. (See *Daly,* TC Memo 2013-147, finding a military contractor's tax home was not where he worked in Iraq and Afghanistan because his ties to those countries were "severely limited and transitory" and his abode was in the U.S.).

Rajcoomar, TC Memo 2017-129.

A payment received by a taxpayer to settle his disability-based discrimination claims against his former employer was not received on account of any physical injury and thus did not qualify for exclusion under §104(a)(2). Although the taxpayer's disability resulted from an injury, that injury was unrelated to his employment, and the claims against his employer related solely to the employer's failure to accommodate his resulting disability.

§104(a)(2) excludes from gross income damages taxpayers receive for personal physical injury or physical sickness. Because emotional distress is not considered a physical injury or physical sickness, taxpayers must include damages they receive for emotional distress in their gross income unless the damages are paid for medical care attributable to the emotional distress. (§104(a))

When a taxpayer receives a payment under a settlement agreement, the nature of the claim that was the actual basis for settlement determines whether such payments are excludable from income.

Before 2013, Lloyd Anthony Rajcoomar was employed by a college as a campus safety officer. In January 2011, he was seriously injured in a car accident unrelated to his employment and subsequently underwent several surgeries as a result. These injuries caused him to go on short-term disability leave from the college in October 2012. He had an ankle surgery in February 2013 and remained on short-term disability leave.

On April 17, 2013, the college informed Rajcoomar that he was near the end of his maximum disability leave period and that, if he did not return to work by April 30, his employment would be terminated. Rajcoomar replied that, if he returned to work, he would be unable to perform his usual patrol duties because he needed to use crutches or wear a protective boot. He asked to be shifted to a more sedentary position, but the college declined to permit such a change, insisting that he return to work "without restrictions." He did not return to work by the deadline and was fired.

In response to his firing, Rajcoomar filed a complaint in May 2013 with the New York State Division of Human Rights (Division) and a similar complaint with the Equal Opportunity Employment Commission. In the Division complaint, he alleged that the college "discriminated against me on the basis of my disability" and that it had failed to offer him a "reasonable accommodation." He asserted that Caucasian employees had been granted the sort of accommodation that he had been denied.

The dispute was ultimately settled in September 2013, and Rajcoomar withdrew his claims in exchange for a monetary payment. The agreement provided for the release of any claims arising under any Federal or State law that prohibit employment discrimination based on, among other things, a disability; did not allege any physical injury or release the college from any claim thereof; and stated that a Form W-2 would be issued for the settlement payment "less legal withholdings."

The college issued Rajcoomar a W-2 reporting the settlement payment as wages for 2013, which he in turn reported as wages on his Form 1040. IRS sent him a deficiency notice for that year that made unrelated adjustments, which he conceded. However, he asserted that he erred in treating the settlement payment as taxable income and that this error effectively offset the amount he owed as a result of the unrelated adjustments.

The Tax Court held that the settlement did not qualify for exclusion under §104(a)(2). The Court found that Rajcoomar's cause of action was based solely on laws prohibiting discrimination on the basis of disability-not on any physical injury or sickness for which the college should be liable. There was no suggestion in the settlement that Rajcoomar made, or released the college from, any physical injury claims. Further, the agreement's provision that a Form W-2 would be issued reflected an understanding that the settlement proceeds were a replacement for lost wages.

At trial, Rajcoomar acknowledged that he had to demonstrate some physical injuries aside from those suffered in the car crash in order for the settlement to qualify for exclusion under §104(a)(2). To that end, he testified that the college's discrimination exacerbated his injuries by causing him headaches but did not point to any supporting medical evidence. Rather, the only medical bills in the record related to the February 2013 ankle surgery and a follow-up appointment. Accordingly, since there was no credible evidence that he suffered any on-the-job physical injury for which the college might have compensated him, and since his complaint and the agreement referred solely to disability-related discrimination, the Court held that Rajcoomar failed to prove that any portion of the settlement proceeds was excludible.

Redfield, TC Memo 2017-71.

Taxpayer was not entitled to a foreign earned income exclusion under §911(a) for the tax year at issue. It came to that conclusion because he failed to make a timely election under Regulation §1.911-7(a)(2)(i), which provides that if the taxpayer is filing a late return and owes income tax after taking the exclusion into account, the taxpayer must attach the election to a Form 1040 filed before IRS discovers that the taxpayer has failed to elect the exclusion.

In general, an individual must include in gross income "all income whatever source derived" (§61(a)), including income earned outside of the U.S. "unless it is expressly excepted by another provision in the Tax Code." (*Commissioner v. Schleier,* (Sup Ct 1995) 75 AFTR 2d 95-2675) One such exception is §911(a), under which a qualified individual may exclude from gross income his foreign earned income up to the inflation-adjusted exclusion amount and subject to certain limitations. (§911(a))

A qualified individual must affirmatively elect the foreign earned income exclusion. (§911(a)) A valid election can be made on:

1. A return that is timely filed (including any extension of time to file). (Regulation §1.911-7(a)(2)(i)(A))

2. A return amending a timely return, where the amended return is filed within the time prescribed for filing a claim for refund, generally three years from the return's due date. (Regulation §1.911-7(a)(2)(i)(B))

3. An original return that is filed within one year after the due date of the return (determined without regard to any extension of time to file). This one year period is not an extension of time for any purpose-it's merely a period during which a valid election may be made on a late return. (Regulation §1.911-7(a)(2)(i)(C))

4. A return filed after the periods described in (1) through (3), above, but only if (a) the taxpayer owes no federal income tax after taking into account the exclusion (Regulation §1.911-7(a)(2)(i)(D)(1)), or (b) the election is attached to a return filed before IRS discovers that the taxpayer failed to elect the exclusion. (Regulation §1.911-7(a)(2)(i)(D)(2)) In either case, the taxpayer must type or legibly print at the top of the first page of the Form 1040 to which the election is attached, "Filed pursuant to Section 1.911-7(a)(2)(i)(D)." (Regulation §1.911-7(a)(2)(i)(D)(3))

In *McDonald,* TC Memo 2015-169, the Tax Court found that the taxpayer had not satisfied the requirements of Regulation §1.911-7(a)(2)(i)(D)(2) for making a timely election. The taxpayer did not file a return for 2009; and in January of 2012, IRS prepared a substitute for return (SFR) for the taxpayer and issued a notice of deficiency based on that SFR. The taxpayer filed a delinquent 2009 return in May of 2012, more than two years after the due date, accompanied by a Form 2555, Foreign Earned Income, claiming a foreign earned income exclusion. IRS sent the taxpayer a second notice of deficiency, disallowing the foreign earned income exclusion for failure to make a timely election.

In *McDonald*, the Tax Court reasoned that IRS had discovered that the taxpayer had failed to make a valid election before she filed her Form 1040 for 2009. IRS had discovered that she had failed altogether to file any return and so discovered that she had failed to file Form 2555 no later than the date on which it issued the SFR in January 2012-months before the taxpayer filed her first Form 1040 for 2009 in May 2012.

Damon Redfield served for 12 years in the U.S. Marine Corps, including several tours of duty in Afghanistan. Sometime before 2010, he left the Marines as a disabled veteran suffering from memory loss and post-traumatic stress disorder. In late 2009, he was offered a civilian position at the Kandahar Air Field in Kandahar Province, Afghanistan. Believing that he had made sufficient progress toward recovery, he accepted that position, arriving in Kandahar in January 2010. Unfortunately, his physical and mental condition worsened, and he was forced to return to the U.S. before completing his 1-year assignment.

He received an extension of time until October 15, 2011, to file his 2010 return. He did not file a return by that date. On May 27, 2014, IRS prepared a SFR. On September 4, 2014, IRS sent Mr. Redfield a notice of deficiency based on the SFR, determining a tax deficiency of $55,217 and various additions to tax.

On October 7, 2014, Mr. Redfield submitted to IRS a delinquent return for 2010 on which he reported wages of $240,211 and total income of $241,140. He included with the return Form 2555 on which he sought to exclude $49,136 of earnings from his work in Afghanistan. After giving effect to that exclusion, he reported $28,622 of tax, $22,510 of payments made, and $6,189 tax due.

IRS sent Mr. Redfield a second notice of deficiency, disallowing his claim for a foreign earned income exclusion because he had not elected to exclude foreign earned income on a prior return and had failed to make a valid election for 2010. That disallowance, along with certain computational adjustments, produced a deficiency of $15,982. IRS also determined late-filing and late-payment additions to tax under §6651(a)(1) and §6651(a)(2) and an accuracy-related penalty under §6662(a).

The taxpayer sought relief in the Tax Court.

While acknowledging the taxpayer's military service, and recognizing that the procedural requirements for making a timely foreign earned income exclusion were not exactly intuitive and that the scars the taxpayer incurred during his military service may have contributed to the tax delinquency at issue, the Tax Court found that it had no alternative but to hold that Mr. Redfield did not make a timely and valid election for 2010. Accordingly, he was not entitled to exclude from gross income any foreign earnings under §911.

The Court reasoned that both IRS and Mr. Redfield agreed that he did not make a timely election under any of methods listed in (1) through (3), above, under Regulation §1.911-7(a)(2)(i)(A), Regulation §1.911-7(a)(2)(i)(B), or Regulation §1.911-7(a)(2)(i)(C). He did not file his 2010 Federal income tax return by October 15, 2011, the extended due date. The return that he filed in October of 2014 did not amend a "timely filed return." And that delinquent return was not "filed within one year after the due date" of his 2010 return.

Further, the Court determined that the same reasoning as in McDonald applied here. Mr. Redfield failed to meet the requirements under Regulation §1.911-7(a)(2)(i)(D)(2). When IRS prepared an SFR for Mr. Redfield on May 27, 2014 that treated all of his wages for 2010 as gross income, IRS evidenced its "discovery" that he had failed to elect the foreign earned income exclusion for that year by filing a Form 1040 accompanied by a properly completed Form 2555. Mr. Redfield did not file his delinquent 2010 return accompanied by a Form 2555 until October 7, 2014, more than four months later.

Observation: The Court noted that, as in *McDonald*, Mr. Redfield did not follow the instruction set out in Regulation §1.911-7(a)(2)(i)(D)(3) by typing or printing the specified statement at the top of the first page of the Form 1040. As in *McDonald*, the Court-based on its determination that the Regulation §1.911-7(a)(2)(i)(D)(2) requirements had not been met-concluded that it did not need to decide whether this omission, standing alone, was sufficient to invalidate an otherwise timely foreign earned income exclusion election.

The Court indicated that the facts of Mr. Redfield's situation (i.e., military service and injury) might be relevant to the penalty and additions to tax that IRS had determined, but they did not alter the requirement for a timely election under the regulations. The Court left for further proceedings IRS's determinations that the taxpayer was liable for late-filing and late-payment additions to tax under §6651(a)(1) and §6651(a)(2) and an accuracy-related penalty under §6662(a).

Ritter, TC Memo 2017-185

The Tax Court has concluded that a payment to an individual borrower from a qualified settlement fund (QSF) that was established to remedy a lender/bank's deficient mortgage servicing and foreclosure practices had to be included in gross income under §61(a).

Generally, except as otherwise provided, gross income means all income from whatever source derived. (§61(a)) In *Glenshaw Glass Co. (S Ct 1955), 47 AFTR 162* , the Supreme Court held that payments were income because they were "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Thus, any receipt of funds or property by a taxpayer is presumed to be gross income unless the taxpayer can demonstrate that the income fits into one of the narrowly construed exclusions provided by law.

A QSF is a fund, account, or trust established under governmental order or approval to resolve or satisfy claims resulting from events that gave rise to certain liabilities; it is a trust under applicable state law, or its assets are otherwise segregated from other assets of the transferor. (Regulation §1.468B-1)

In determining the tax treatment of a payment to settle a claim, a court must determine in lieu of what the damages were awarded. (*Raytheon Products Corporation v. Commissioner ,* (CA 1 1944) 32 AFTR 1155) With respect to distributions from a QSF, inclusion in the payee's gross income is generally determined by reference to the claim in respect of which the distribution is made, and as if the distribution were made directly to the payee by the transferor to the fund.

On December 7, 2009, JP Morgan Chase Bank (Bank) filed a complaint to foreclose a mortgage loan on Thomas Ritter's principal residence. A judgment of foreclosure was entered against Ritter and in Bank's favor on January 20, 2010.

Ritter filed a Chapter 7 bankruptcy petition on March 8, 2010. Bank filed a motion for relief from stay in that bankruptcy proceeding on March 17, which was granted on Apr. 6, 2010. The bankruptcy court granted Ritter a discharge under Chapter 7 on July 2, 2010.

On September 22, 2010, the chancery court issued an order approving the report of sale and distribution and confirming the foreclosure sale of Ritter's then-residence.

In 2011, Bank entered into a settlement agreement known as the Independent Foreclosure Review (IFR) with the Office of the Comptroller of the Currency (OCC) pursuant to which Bank agreed to take certain actions in order to remedy "deficiencies and unsafe or unsound practices" in its residential mortgage servicing and handling of foreclosure proceedings. Ritter was one of the borrowers who was harmed by these unsound practices.

The settlement agreement was subsequently amended to provide for Bank's establishment of a QSF under Regulation §1.468B-1 from which payments would be made to borrowers who were harmed by its banking practices and who had pending or completed foreclosures with respect to their primary residences during 2009 or 2010-including Ritter.

The settlement agreement, as amended, did not require a borrower to show financial harm or request a review through the IFR in order to receive a payment. The amendment also expressly provided that payments did not "in any manner reflect specific financial injury or harm that may have been suffered by borrowers receiving payments."

The amount received from the QSF was based on a variety of factors, and borrowers were categorized by their loan file characteristics and whether or not they requested a review through the IFR. Ritter, who was categorized as a borrower whose mortgage loan servicer initiated or completed foreclosure while he was protected by Federal bankruptcy law, and who did not seek review through the IFR, was eligible for a standard payout of $31,250. Ritter's category of borrowers was not eligible for any payment representing lost equity.

The QSF sent Ritter and IRS a Form 1099-MISC reporting "other income" of $31,250 with no tax withheld. Ritter did not include the $31,250 in gross income on his 2013 return. IRS subsequently issued a determination in which it concluded that he should have.

The Tax Court concluded that the $31,250 payment was taxable under §61(a) as an accession to wealth, and no provision of the Code specifically provided for its exclusion.

The Court reasoned that the payment was made to remedy certain deficient practices in Bank's mortgage servicing and handling of foreclosures. The payment did not reflect financial injury or harm suffered, and it also expressly did not include any amounts for lost equity.

The Court also found no indication that the $31,250 payment was, or was intended to be, a deemed increase or decrease in the amount realized by Ritter from the foreclosure with respect to the mortgage loan on his then principal residence. The Court noted that Ritter did not rely on Rev Rul 2014-2, 2014-2 IRB 255 (which provided limited tax relief to taxpayers who received National Mortgage Settlement (NMS) payments due to the foreclosure of their principal residence), but nonetheless analyzed its potential applicability and concluded that NMS payments are materially distinguishable from IFR payments and thus Rev Rul 2014-2 does not control their tax treatment.

Rutkoske, Sr., (2017) 149 TC No. 6.

The Tax Court has determined that two brothers were not "qualified farmers" under §170(b)(1)(E) and thus their deduction for a qualified conservation contribution was subject to the regular 50% contribution base limit. In so holding, the Court found held that neither the proceeds from the sale of the conservation easement, nor the proceeds from the subsequent bargain sale of the underlying property, were income "from the trade or business of farming" under §2032A(e)(5).

Under §170(a), an individual is allowed a deduction for any charitable contribution (as defined in §170(c)) payment of which is made within the tax year. §170(b)(1)(A) generally limits the amount of the deduction to 50% of the individual's "contribution base" (which §170(b)(1)(G) defines as the taxpayer's adjusted gross income, computed without regard to any net operating loss for the tax year, less the value of his or her other charitable contributions for the year). Donating taxpayers, in general, may carry forward a suspended donation to each of the five succeeding taxable years, subject to the 50% contribution base limitation. (§170(d)(1))

However, §170(b)(1)(E)(iv) provides a special rule for contributions of property used in agriculture or livestock production. If the individual is a "qualified farmer or rancher" for the tax year for which the contribution is made, then that individual may deduct the value of the donation up to 100% of the his or her contribution base, less the amount of all other charitable contributions allowable under §170(b)(1) made during the year. A "qualified farmer or rancher" is an individual whose gross income from the trade or business of farming (within the meaning of §2032A(e)(5)) is greater than 50% of the individual's gross income for the tax year. (§170(b)(1)(E)(v))

Activities listed in §2032A(e)(5), revenues of which constitute income from the trade or business of farming, include cultivating the soil; raising or harvesting any agricultural or horticultural commodity; raising, shearing, feeding, caring for, training, and management of animals; handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state but only if the owner, operator, or tenant of the farm regularly produces more than one-half of the commodity; and planting, cultivating, caring for, or cutting trees, or preparing (other than milling) trees for market.

Under §703(a), the taxable income of a partnership is generally computed in the same manner as in the case of an individual. However, partnerships are required to "state separately"-that is, to compute as separate items-certain classes of income and deductions. These classes of income and deductions are then directly passed through to the partnership's partners, who take them into account for tax purposes by including their distributive share of each of these classes of income and deductions as separate items on their tax returns. (§702(a)(4))

Included among the income and deductions that must be separately stated and passed through to partners are charitable contributions. (§702(a)(4)) The character of each item passed through to the partners and separately stated on their returns has the same character as if it was realized or incurred directly from the source from which realized by the partnership. (§702(b))

In 2009, brothers Mark and Felix Rutkoske were in the business of farming. They owned several parcels of land through numerous entities, including a 355-acre parcel (the property) which they held through Browning Creek, LLC (Browning Creek), a limited liability company treated as a partnership for tax purposes in which each was a 50% member. Browning Creek was in the business of leasing land, and it leased the property to Rutkoske Farms, a partnership through which the Rutkoske brothers farmed the property as well as the other parcels they owned.

On June 5, 2009, Browning Creek conveyed a conservation easement to Eastern Shore Land Conservancy, Inc. (Eastern Shore), a public charity under §501(c)(3), restricting the development rights attached to the property in exchange for $1.5 million. In connection with the granting of the easement, Browning Creek obtained an appraisal which set forth the fair market value (FMV) of the unencumbered property as of June 5, 2009, as $5 million and the FMV of the property after the granting of the conservation easement as $2.1 million. After conveying the conservation easement, later on June 5, 2009, Browning Creek sold its interest in the property to Quiet Acre Farm, Inc. (Quiet Acre) for $2 million

Browning Creek reported that its total basis in the property was $1.7 million, allocating $200,000 of this amount to the conservation easement and $1.5 million to its remaining interest in the property. Browning Creek reported a capital gain of $1.8 million from the sale of the property: $1.3 million from the sale of the conservation easement, and $500,000 from the sale of its remaining property interest. Browning Creek also reported a noncash charitable contribution for the conservation easement of $1.4 million-the difference between the $5 million purported value of the property before the conveyance of the conservation easement and the $2.1 million purported value of the property after the conveyance of the easement, minus the $1.5 million Browning Creek received from the sale of the conservation easement.

On their 2009 individual tax returns, as 50% partners of Browning Creek, the brothers each claimed noncash charitable contribution deductions of $700,000 on Schedules A, Itemized Deductions-the full deduction available to qualified farmers under §170(b)(1)(E)(v). The brothers reported the gain from the sale of Browning Creek's interest in the property to Quiet Acre on Schedules D, Capital Gains and Losses, of their respective income tax returns as long-term capital gain passed through from Browning Creek, with each brother reporting gains of $900,000 (i.e., half of the $1.8 million capital gain from the sale of the property).

For 2009, Mark Rutkoske reported wage income of $16,800, interest income of $453, and a loss from partnerships and S corporations of $180,000. For 2009, Felix and Karen Rutkoske reported wage income of $28,745, interest income of $586, and a loss from partnerships and S corporations of $180,000.

The issue before the Tax Court was whether the brothers were "qualified farmers" entitled to the heightened contribution base-i.e., whether each brother's gross income from the trade or business of farming exceeded 50% of his total gross income for the year. Resolution of this issue turned on whether the proceeds from the sale of the property, as well as the proceeds from the sale of its associated development rights, constitute income from the trade or business of farming under §2032A(e)(5).

IRS asserted that the sale of land and the rights the develop land are not activities listed in §2032A(e)(5), and that proceeds therefrom do not constitute income from the trade or business of farming under §170(b)(1)(E)(v). The brothers, however, claimed that the income derived from the sale of the conservation easement as well as the sale of the property does qualify as income derived from the trade or business of farming, maintaining that the business of farming requires monetary capital and investment in tangible physical capital, including land, buildings and structures, and machinery and equipment. They reasoned that farm real estate is "an asset integral" to the activities listed in §2032A(e)(5), and that proceeds from the sale of real estate used in the business of farming thus generates income from the trade or business of farming.

The Tax Court, after first finding that the brothers were treated under Regulation §1.703-1(a)(2)(iv) as having directly conveyed the conservation easement to Eastern Shore, concluded that the neither the sale of the property nor the sale of its development rights constitutes an activity that is included in the trade or business of farming as defined by §2032A(e)(5). Accordingly, the brothers were not "qualified farmers" and they were limited under §170(b)(1)(E)(i) to a charitable contribution deduction of 50% of their respective contribution bases with respect to the conservation easement.

The Tax Court acknowledged that an individual engaged in the trade or business of farming will likely engage in activities beyond those listed in §2032A(e)(5). However, the Court stated that §170(b)(1)(E) is "a narrowly tailored provision intended to provide a tax benefit for a specific action, namely, the contribution of conservation easements by qualified farmers," and the Court declined to broaden the scope of qualifying activities as argued by the brothers. The Court stated that, when determining if an individual is a qualified farmer under §170(b)(1)(E)(iv), it looks to the income derived from the sale of the agricultural and/or horticultural products created when engaging in these activities, not from the sale of the land on which the agricultural and/or horticultural products are grown.

Further, the Court acknowledged that the brothers are farmers, that they continued to be farmers after the property was sold, and that they used most of the proceeds derived from the sale of the property in their continuing farming operations. However, it noted that being a farmer does not make an individual a "qualified farmer" under §170(b)(1)(E)(iv)(I), and that the definition provided in the statute was unambiguous.

The Court also found that, even if it were to agree with the brothers' interpretation of §170(b)(1)(E), they still would not prevail. Although the brothers were treated as having directly contributed the property, the character of the deduction flows through from Browning Creek-which was not in the business of farming, but rather the business of leasing real estate.

Rutter, TC Memo 2017-174

The Tax Court has concluded that a scientist who made numerous advances to a biotech company was not entitled to take a business bad debt deduction under §166(a).

§166(a)(1) allows as a deduction the amount of any bona fide debt that becomes worthless within the tax year. §166 requires that: (1) a bona fide debt existed between the taxpayer and his debtor; (2) the debt be created or acquired in connection with the taxpayer's trade or business; and (3) the debt became worthless in the year the bad debt deduction was claimed.

William J. Rutter is a world-renowned scientist in the field of biotechnology. In June 2002, he incorporated iMetrikus International (IM), and iMetrikus (which was acquired by the taxpayer in 1999 and originally called Healthvantage, Inc.) became its wholly owned subsidiary (the Tax Court referred to these companies collectively as IM). IM was a “telehealth” company that developed technology systems to enable remote monitoring of patients' health.

IM had an unusual capital structure. Although Mr. Rutter was its driving force, he owned no common stock. IM had about 70 common shareholders, but the common stock formed a minuscule portion of its capital structure. IM's primary funding source took the form of cash advances from Mr. Rutter. Between September 2000 and February 2002, he made 39 separate cash advances to IM totaling approximately $10.6 million. For each advance, IM executed a substantially identical convertible promissory note. Each note provided that IM had the right to convert the note into common or preferred stock depending on certain events, and each of the 39 notes bore 7% interest. IM duly paid all interest on these notes when due.

Between February 2002 and May 2005, he advanced another $22 million. Only $3.4 million of these advances was covered by promissory notes. For the remaining $18.6 million, he received no promissory note or other evidence of indebtedness. IM recorded all these advances as loans on its books, and these advances accrued interest at 7%. But after February 2002, IM paid no interest on any of this purported indebtedness.

By May 2005, the taxpayer had advanced approximately $43.4 million to IM. That same month, IM converted the entirety of this purported indebtedness to preferred stock which gave the taxpayer preferred stock with a face value of $43.4 million. After this conversion, roughly 78% of IM's capital structure consisted of preferred stock owned by the taxpayer.

Between May 2005 and December 2009, the taxpayer made additional cash advances to IM totaling $43.04 million. These advances were IM's sole source of funding during this period. The taxpayer generally made these advances monthly or semimonthly in amounts sufficient to cover IM's budgeted operating expenses for the ensuing period. IM executed no promissory notes for these advances and furnished no collateral, but recorded these advances on its books as loans and accrued interest at the 7% rate. But it never paid any interest on any of this purported indebtedness. As of December 31, 2009, the balance of the taxpayer's open-account advances to IM, including accrued interest, was approximately $47.5 million. That sum, coupled with his $43.4 million of preferred stock, constituted roughly 92% of IM's capital structure as of that date.

IM incurred substantial losses in most years of its existence. In December 2009, the taxpayer decided to write off a portion of the amount he had advanced, executing a certificate of debt forgiveness for $8.55 million and receiving a $34.5 million promissory note for the balance.

On his 2009 return, the taxpayer reported an $8.55 million business bad debt loss as a deduction against ordinary income, reflecting the write-down of his advances to IM. The taxpayer claimed this loss corresponded to advances he had made during 2005 and 2006 after the conversion of his previous advances to preferred stock. No accrued interest was included in the $8.55 million write-down.

On audit, IRS disallowed the business bad debt deduction in full.

The Tax Court considered each of the factors in the Ninth Circuit's decision in *Hardman*, (CA 9 1987) 60 AFTR 2d 87-5651 (since the case was appealable to that circuit) and, evaluating the factors overall, found that the taxpayer's advances, including the advances corresponding to his $8.55 million write-down, were equity investments and not debt:

1. **Labels on the documents.** The issuance of a note evidences debt, and the issuance of stock indicates an equity contribution. The absence of a promissory note or other evidence of indebtedness for the $8.55 million of advances supported characterizing them as equity. The $43.04 million involved here was advanced between May 2005 and December 2009; IM did not issue the taxpayer a single promissory note to cover any of these advances. (The Court found the March 2010 promissory note for $34.5 million to consolidate the portion of his advances that he chose not to write off was without probative value in the debt-vs.-equity analysis: it did not cover the $8.55 million of advances for which he claimed a loss, and it was not created during the 2009 tax year. It was a self-serving document created in connection with his year-end tax planning.)

2. **Fixed maturity date.** The absence of a fixed maturity date indicates that repayment depends on the borrower's success, which in turn supports characterization as equity. Because IM issued no promissory notes for any of the advances at issue, there was of necessity no fixed maturity date. The absence of any fixed maturity dates supported characterizing the advances as equity.

3. **Payment source.** Payments that depend on earnings or come from a restricted source indicate an equity interest. IM had aggregate losses of $82.7 million during 1999-2009, and its expenses vastly exceeded its revenue for all relevant years. As of December 31, 2009, it had made no payments of principal or interest on the taxpayer's $43.04 million of cash advances. For much of the period after May 2005, IM was kept afloat because the taxpayer continued to provide monthly or semimonthly cash infusions keyed to IM's expected cash needs for the ensuing period. Thus, the most likely source of repayment of his advances would be further cash infusions from the taxpayer. This did not support characterizing his advances as debt.

4. **Right to enforce payment of principal and interest**. A definite obligation to repay, backed by the lender's rights to enforce payment, supports a debt characterization. Although the taxpayer's advances were shown as loans on IM's books, there was no written evidence of indebtedness fixing IM's obligation to repay at any particular time. None of the taxpayer's advances was secured by any collateral. And even if he were thought to have a right to enforce repayment, that right was nugatory because his continued cash infusions were the only thing keeping IM afloat. Had he enforced repayment, he would simply have had to make a larger capital infusion the following month. This strongly supported characterization of his advances as equity.

5. **Participation and management**. An increase in a shareholder's interest in a corporation or management as a result of advances made indicates an equity interest. However, the Court found that evaluation of this factor was tricky because IM had an unusual capital structure. Although the taxpayer had de facto control, he literally owned no common stock. But through his cash advances and preferred stock, he held about 92% of IM's capital. He had complete control of the company by virtue of his status as its sole funder. To the extent this factor was relevant, it supported characterizing the advances as equity.

6. **Status relative to regular creditors.** The fact that the purported creditor subordinates his right to repayment to that of other creditors supports an equity characterization. It was significant that the taxpayer had, in absolute terms, none of the rights that a “regular creditor” would have: there was no promissory note, no maturity date, no collateral, no protective covenant, no personal guaranty, and no payment of interest. No “regular creditor” would have lent funds to a loss-ridden company like IM on such terms. This factor, to the extent relevant, supported characterizing the advances as equity.

7. **Parties' intent.** The taxpayer did not execute promissory notes for any of the advances at issue. He received no interest on his advances and made no effort to collect interest or enforce repayment of principal. Although IM recorded the advances as loans and accrued interest on them, his control over the company gave him ultimate discretion to decide whether and how repayment would be made. In fact, he expected to be repaid, as a venture capitalist typically expects to be repaid, upon sale of IM to a third party or a third-party investment in IM. This factor weighed in favor of treating the advances as equity.

8. **Inadequate capitalization.** Advances to a business may properly be characterized as equity if its capitalization is sufficiently poor as to make repayment unlikely. Between May 2005 and December 2009, the taxpayer's aggregate cash advances ($43.04 million) roughly equaled the face value of IM's preferred stock ($43.4 million). While this suggested that IM's capitalization may have been adequate, that fact would not seem compelling here. Normally, a large “equity cushion” is important to creditors because it affords them protection if the company encounters financial stress: the creditors will not be at risk unless the common and preferred shareholders were first wiped out. But because the taxpayer himself supplied almost 100% of IM's “equity cushion,” he would not derive much comfort from the latter prospect. The Court concluded that this factor slightly favored the taxpayer or was neutral.

9. **Identity of interest.** This factor examines whether the advance is made by a sole shareholder. The taxpayer was not IM's sole shareholder, but he controlled the company and, during the relevant period, owned between 78% and 92% of IM's capital structure. There was thus a considerable, albeit incomplete, identity of interest between the taxpayer in his capacities as owner and alleged lender. The Court found that this factor slightly favored IRS or was neutral.

10. **Payment of interest.** IM made no interest payments on any of the advances that the taxpayer made between February 2002 and December 2009. This fact strongly supported characterization of the advances as equity

11. **Ability to obtain loans from other sources**. Evidence that the business could not have obtained loans from outside sources supports characterization of an insider's advances as equity. The evidence was clear that no third party operating at arm's length would have lent $43 million to IM between May 2005 and December 2009 without insisting (at a minimum) on promissory notes, regular interest payments, collateral to secure the advances, and a personal guaranty from the taxpayer. This was especially so where (as here) the purported debtor was losing about $8 million a year and could not fund its operations without the taxpayer's monthly cash infusions. IM's financial condition had been extremely precarious in every year since its inception. This final factor weighed in favor of equity characterization.

The Tax Court also found that the advances were not a business “debt,” rejecting the taxpayer's contention that he made his advances in pursuit of his trade or business as a “lender” or as a “promoter” of startup companies.

For nonbusiness bad debt held by a taxpayer, other than a corporation, §166(a)(1) does not apply, and the taxpayer is only allowed a short-term capital loss for the tax year in which the debt becomes completely worthless. (§166(d)(1), Regulation §1.166-5(a)(2)) To be eligible to deduct a loss as a business bad debt, a taxpayer must show that he was engaged in a trade or business and that the debt was proximately related to his trade or business. (*U.S. v. Generes*, (S Ct 1972) 29 AFTR 2d 72-609, Regulation §1.166-5(b)) The management of one's investments, no matter how extensive, is not a trade or business. (*Whipple v. Commissioner,* (S Ct 1963) 11 AFTR 2d 1454)

The taxpayer advanced more than $80 million to IM without executing promissory notes or collecting interest; no bank or other professional lender operates in this fashion. He did not collect a penny of interest on his advances during the eight-year period beginning March 2002. Similarly, he sought no repayment of principal. The taxpayer hoped to be repaid upon ultimate sale of IM to a third party. This was not how lenders expect to make a profit. And the taxpayer was not in the business of being a “promoter” of biotech firms where he was entitled to no compensation other than a normal investor's return. Here, the taxpayer received no fees, commissions, or other compensation for his services. He expected to receive the return that equity investors normally hope for—namely, long term gain upon appreciation or sale of IM's assets.

Debt was not worthless in 2009. The Tax Court also concluded that IRS did not abuse its discretion in determining that the taxpayer was not entitled to a deduction of $8.55 million for a partially worthless debt for 2009.

The year in which a purported debt becomes worthless must be fixed by identifiable events that make it reasonable for the lender to abandon any hope of recovery. (*Crown,* (1981) 77 TC 582) The taxpayer's burden is especially great where (as the Court found here) he seeks to deduct a partially worthless debt. Before a taxpayer may deduct a debt in part, he must be able to demonstrate to IRS's satisfaction the amount that is worthless and the part which has been charged off. (Regulation §1.166-3(a)(2)(iii))

The Court found that the taxpayer appeared to have had a reasonable hope of recovering on his investments—that was presumably why he continued to advance another $37.75 million to IM during 2010-2013. The Court rejected the taxpayer's contention that the purported collapse of IM s partnership discussions with Google was the identifiable event in determining that IM's value had declined by 74% from year-end 2008. There was no factual support for this hypothesis: IM's discussions with Google were ongoing at year's end 2009 and did not turn south until mid-2010.

The Court determined that the taxpayer advanced $43.04 million to IM on an open account, as needed by IM, as if he were extending a line of credit. Like a bank line of credit, this was properly regarded as a single aggregate debt. The $8.55 million number he chose for the write-down appeared to have been selected because it approximated the income the taxpayer realized earlier in 2009 from another of his startup companies. He made no effort to tie this write-down to IM's actual financial condition or ability to repay.

St. Claire, TC Memo 2016-192.

The Tax Court illustrates various aspects of the rules that allow taxpayers to recover administrative and/or litigation costs from IRS and has held that IRS was substantially justified when it repeatedly questioned the validity and completeness of a taxpayer's documentation that turned out to be proper.

A prevailing party may recover reasonable administrative costs and litigation costs incurred in a tax matter brought by or against IRS. (§7430(a)) The prevailing party is the party which has "substantially prevailed with respect to the amount in controversy or has substantially prevailed with respect to the most significant issue or set of issues presented." (§7430(c)(4)(A)) A party is not treated as the prevailing party if IRS establishes that its position was substantially justified. (§7430(c)(4)(B)(i))

§7430(a)(1) and §7430(a)(2) limit the prevailing party to an award of "reasonable" litigation and administrative costs. §7430(c)(2) limits the term "reasonable administrative costs" to costs paid or incurred on or after the earliest of (1) the date on which the taxpayer receives a notice of decision from the Appeals Office, (2) the date of the notice of deficiency, or (3) the date on which IRS mails a first letter of proposed deficiency giving the taxpayer a right to protest the proposed deficiency to the Appeals Office.

§7430(c)(1)(B)(iii) (and its flush language) generally limits the hourly rate for attorney's fees to $125 per hour, plus an adjustment for cost of living, unless the Court determines that a special factor such as the limited availability of qualified attorneys for the proceeding, the difficulty of the issues presented, or the local availability of tax expertise justifies a higher rate. For purposes of this case, the statutory rate for attorney's fees incurred in 2015 and 2016 was $200 per hour. (See Revenue Procedure 2014-61, 2014-47 IRB 860; Revenue Procedure 2015-53, 2015-44 IRB 615) Under Tax Court Rule 232(e), the taxpayer bears the burden of proving that the amount of costs he claimed is reasonable.

§152(e) governs the assignment of dependency exemptions in the case of parents who are divorced or legally separated and who provide over one-half of their child's support during a calendar year in which the child is in the custody of one or both parents for more than one-half of the calendar year. In this scenario, a noncustodial parent may become entitled to a dependency exemption deduction for minor children if two conditions are met: (i) the custodial parent signs a written declaration releasing his or her claim to the exemption; and (ii) the noncustodial parent attaches such written declaration to his or her tax return for the tax year. (§152(e)(2)(A) and §152(e)(2)(B)) The required written declaration can be set forth on a completed Form 8332 or a written statement conforming to the substance of the form.

The taxpayer, Mr. St. Claire, was divorced from his wife, Ethlyn. The court that entered the judgment dissolving the marriage reserved ruling on various issues including child custody. The couple had three children.

St. Claire timely electronically filed his 2012 return on which he claimed deductions for the children, but it was rejected by IRS. Thereafter, on June 15, 2013, his attorney, Mr. Gibson, sent a letter to IRS, together with print Form 1040, Forms 8332 signed by Ethlyn, and copies of the children's birth certificates that established that St. Claire was the children's father. The letter said that Gibson surmised from IRS's rejection notice that someone had already claimed the children on another tax return, and said that Ethlyn represented to St. Claire that she had not even filed a 2012 return and that she had given him permission, as evidenced by the Form 8332, to take deductions for the children.

Observation: The facts are not clear as to whether any of the abovementioned attachments to Form 1040 were filed with the original electronically-filed return.

On November 18, 2013, IRS sent a letter to St. Claire informing him that his tax return was under examination and requesting that he provide information to substantiate the dependency exemptions. Mr. Gibson sent a letter to IRS and attached copies of three Forms 8332. While each form included a signature under Part II (release for future years), that part showed 2012 as the only year. The signatures on the three forms appeared fairly uniform, with some minor variations.

On April 4, 2014, IRS sent a Form 886-A, Explanation of Items, to Mr. Gibson requesting the divorce decree and any written agreement showing which parent had custody and/or was entitled to claim the dependents. Mr. Gibson promptly sent a letter to IRS and attached several documents related to St. Claire's divorce proceedings. Mr. Gibson explained that issues concerning child custody had never been resolved.

On November 7, 2014, IRS sent a letter to Mr. Gibson stating that St. Claire was not entitled to the dependency exemption deductions "because the Form 8332 provided appears to be altered." The letter invited St. Claire to provide any additional documents that he wanted IRS to consider and stated that he was entitled to file an administrative appeal.

Mr. Gibson promptly replied, disagreed with the suggestion that the Forms 8332 had been altered, and questioned how IRS had made that determination without a sample of Ethlyn's signature. He further asserted that, because neither parent had been awarded legal custody of the children, St. Claire should be entitled to claim the children as his dependents without further inquiry. Arguing that St. Claire had provided all required documentation, he requested that the matter be referred to IRS's Appeals Office.

On March 6, 2015, IRS sent a letter saying that it would not allow the dependent deductions for various reasons including that St. Claire had not proved that he submitted the Forms 8332 with his return and had not provided any documentation that included Ethlyn's signature. It also denied the request for review by the Appeals Office.

On June 19, 2015, IRS issued a notice of deficiency that denied the dependent deductions, and thereafter, St. Claire petitioned the Tax Court. Thereafter, IRS contacted Ethlyn who verified that she had signed the Forms 8332, and, months later, in its answer to the petition, IRS conceded the adjustments in the notice of deficiency.

The Court began its analysis by synthesizing rules derived from several cases on the subject of the "substantially justified" standard.

To establish that its position was substantially justified, IRS must show that its position was "justified to a degree that could satisfy a reasonable person" or that its position has a "reasonable basis both in law and fact." (*Swanson,* (1996), 106 TC 76) A position has a reasonable basis in fact if there is relevant evidence that a reasonable mind might accept as adequate to support a conclusion. (*Corkrey*, (2000) 115 TC 366) In determining whether the position of IRS was substantially justified, courts must consider the basis for the legal position and the manner in which the position was maintained. (*Wasie,* (1986) 86 TC 962) A significant factor to be considered is the information available to IRS at the time it established its position. (Regulation §301.7430-5(d)(1))

IRS is entitled to maintain its position, for purposes of determining whether it was substantially justified, until adequate substantiation is received from the taxpayer. Further, where the resolution of adjustments hinges on factual determinations, IRS is not required to concede the adjustments until it has received, and has had reasonable time to review, sufficient substantiation for the matter in question.

IRS's decision to concede a case is not conclusive that the taxpayer is entitled to an award under §7430, but a concession is a factor that may be considered.

Where a taxpayer seeks both litigation and administrative costs, courts apply the substantially justified standard as of the two separate dates on which IRS took a position-first in the administrative proceeding and later in the court proceeding. For purposes of the administrative proceeding, IRS's position is that taken on the earlier of the date of the receipt by the taxpayer of the notice of decision of the Appeals Office or the date of the notice of deficiency. (§7430(c)(7)(B)) Generally, IRS's position in the judicial proceeding is established in the answer to the petition.

The Court concluded that St. Claire was not entitled to an award of any administrative costs incurred before March 6, 2015.

IRS took the position in the notice of deficiency (and throughout the administrative proceedings) that St. Claire had not properly substantiated the dependency exemptions. IRS argued that its position was substantially justified until March 6, 2015, when St. Claire was notified that his request for Appeals Office review was denied. St. Claire countered that IRS's position was not substantially justified because he provided adequate substantiation from the outset of the examination by presenting IRS with copies of the Forms 8332 in question.

The Court said that, although St. Claire provided IRS with copies of Forms 8332, IRS was not obliged to accept those documents at face value. Rather, IRS had the right to develop and was justified in developing a record regarding St. Claire's relationship with Ethlyn and the children, and, ultimately, to challenge the authenticity of the Forms 8332. That was particularly so given that some individual had attempted to claim the children as dependents earlier in the 2012 tax return filing season; that the signatures on the Forms 8332, although substantially similar, were not identical; and the forms were completed in a way that left some ambiguity as to whether they were intended to apply only to 2012 or to apply to 2012 and all years thereafter. Considering all the circumstances, until March 6, 2015, IRS's position was reasonably based in fact and law and therefore was substantially justified and represented a good-faith effort to enforce the internal revenue laws.

The Court also limited St. Claire's litigation cost award.

IRS asserted that St. Claire was not entitled to an award of litigation costs because all substantive adjustments were conceded in its answer to the petition. St. Claire maintained that, inasmuch as IRS conceded that it was unreasonable to deny him the opportunity for Appeals Office review (and the opportunity to resolve the matter administratively), he should be entitled to an award that includes the cost of preparing and filing the petition for redetermination.

The Court said, as noted by the case law, Congress has mandated that claims for litigation and administrative costs be reviewed in the light of IRS's position at distinct times, a process that allows

IRS to change its position. In evaluating a taxpayer's claim for litigation costs, courts evaluate the reasonableness of IRS's position as set forth in its answer to the petition.

It said that, because IRS had verified the authenticity of the Forms 8332 and conceded the disputed adjustments in its answer to the petition, IRS's litigation position was substantially justified and therefore St. Claire was not entitled to an award of litigation costs related to the preparation and filing of the petition.

The Court then looked to the litigation costs that St. Claire incurred in filing and prosecuting his motion for litigation and administrative costs. The record reflected that Mr. Gibson spent 15.7 hours preparing and litigating the motion for costs.

The Court said that reasonable litigation costs generally encompass the costs incurred to litigate a claim for litigation and administrative costs. Courts evaluate the costs that the taxpayer incurred to litigate his motion for costs, however, against his level of success in doing so.

The Court said that St. Claire failed to persuade it that he was entitled to reasonable administrative costs beyond the costs that IRS conceded or (as discussed more fully below) that he was entitled to attorney's fees in excess of the statutory rate. Therefore, it awarded him litigation costs to cover four hours (or approximately one-quarter) of the time that Mr. Gibson devoted to preparing and prosecuting St. Claire's motion for costs.

The Court found that the facts in this case did not warrant an hourly rate for attorney services in excess of the $200 statutory rate.

Mr. Gibson submitted to the Court a declaration stating that his $325 hourly rate is reasonable "based on the prevailing community rate" and his expertise in tax matters. Mr. Gibson stated that St. Claire could not find an attorney to represent him at less than $325 per hour and that it made practical sense for him to provide legal representation given that he had prepared St. Claire's tax return for 2012 and was already familiar with the underlying facts of the case.

But the Court said that general expertise in tax law in itself is not a special factor warranting a fee award in excess of the statutory rate under §7430. Moreover, there was nothing particularly unique or unusual about these proceedings (involving a simple question of substantiation) that presented extraordinary difficulty or required specialized expertise.

Salloum, TC Memo 2017-127.

A doctor's partial repayment of an amount advanced to him in connection with a recruiting agreement could not be deducted as an expense on Schedule C, Form 1040. The amount advanced to him was a bona fide loan.

The determination of whether a transfer of funds is a loan is a question of fact. For a transfer of funds to constitute a loan, at the time the funds are transferred there must be an unconditional obligation (i.e., an obligation that is not subject to a condition precedent) on the part of the transferee to repay, and an unconditional intention on the part of the transferor to secure repayment of, the funds. (*Haag,* (1987) 88 TC 604, aff'd without published opinion, CA-8); *Dickinson,* TC Memo 2014-136)

Whether a transfer of funds constitutes a loan may be inferred from factors surrounding the transfer, including the existence of a debt instrument, the existence of a written loan agreement, the provision of collateral securing the purported loan, the accrual of interest on the purported loan, the solvency of the purported borrower at the time of the purported loan, the treatment of the transferred funds as a loan by the purported lender and the purported borrower, a demand for repayment of the transferred funds, and the repayment of the transferred funds. (*Haag; Clark,* (1952) 18 TC 780, aff'd (CA 2 1953) 44 AFTR 70; *McFadden,* TC Memo 2002-166)

A taxpayer cannot deduct the repayment of a loan. (*Brenner,* (1974) 62 TC 878; *Crawford,* (1928) 11 BTA 1299)

In 2009, a hospital recruited Dr. Ellis Salloum, a vascular surgeon, to join its facility as an independent contractor. As part of the recruiting agreement, which called for him to remain on staff for at least 36 months, the hospital loaned Salloum $146,500, which was advanced in monthly installments over six months. The loan carried interest and was evidenced by a promissory note. As security for the payment of principal and interest on the loan, Dr. Salloum granted the hospital a security interest in, and irrevocably assigned to the hospital, all the accounts of his private practice of medicine.

Dr. Salloum had an unconditional obligation to repay the loan, but that obligation was subject to a condition subsequent: If he worked for the hospital for at least six months, it would forgive 1/30th of the loan for each month after the initial 6-month advance period that he remained on staff. The documents made it clear that amounts forgiven, if any, (as well as any imputed income) would be reported on Form 1099.

The hospital did not include the $146,500 loan in Form 1099-MISC or in another information return that it issued to Dr. Salloum for 2009, and he did not include the $146,500 loan in gross income for that year. In February of 2011, Dr. Salloum terminated his employment with the hospital. As per the agreement, during 2012 he made payments to the hospital totaling $46,883.54 in repayment of the remaining balance of the $146,500 that the hospital had loaned to him in 2009.

On his Schedule C, Profit or Loss From Business for 2012, Dr. Salloum claimed the $46,883.54 repayment as "Other expenses." IRS disallowed the claimed deduction on Schedule C and said Dr. was liable for the §6662(a) accuracy-related penalty as well.

The Tax Court held that the amount transferred by the hospital to Dr. Salloum was a loan, and thus he was not entitled to deduct the loan's partial repayment.

Various factors indicated that the transfer of funds from the hospital to Dr. Salloum constituted a loan, including the following: he signed a promissory note; there was a loan agreement; he agreed to pay interest on the $146,500 that he received from the hospital at a specified rate; he agreed to secure the repayment of the $146,500 loan and the interest on it by granting the hospital a security interest in all accounts receivable of his private practice of medicine; he had the ability to repay the $146,500 that CMC transferred to him and repaid part of it; and he and the hospital treated the amount transferred to him as a loan that was not included on a Form 1099-MISC for tax year 2009 and was not included in Dr. Salloum's income for 2009.

The Tax Court also hit Dr. Salloum with the accuracy-related penalty under §6662(a).

Ellen Sas, TC Summary Opinion 2017-2.

Taxpayers must deduct legal fees that they incurred as miscellaneous itemized deductions subject to the 2% limitation in §67(a), rather than as either legal fees paid in connection with an action involving a claim of unlawful discrimination under §62(a)(20) or as ordinary and necessary business expenses under §162.

Under §62(a)(20), attorneys' fees and court costs paid by, or on behalf of, a taxpayer are deductible from gross income to determine adjusted gross income (AGI) in connection with an action involving:

a. A claim of unlawful discrimination (as defined under §62(e);

b. A claim of a violation of subchapter III of chapter 37 of title 31, United States Code (Claims Against the U.S. Government); or

c. A claim made under section 1862(b)(3)(A) of the Social Security Act (42 U.S.C. 1395y(b)(3)(A)) (private cause of action under the Medicare Secondary Payer statute).

The above-the-line deduction is limited to "the amount includible in the taxpayer's gross income for the tax year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim." (§62(a)(20))

§162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business.

The deductibility of legal fees under §162 depends on the origin and character of the claim for which the legal fees were incurred and whether that claim bears a sufficient nexus to the taxpayer's business or income-producing activities. The Supreme Court stated that "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test." (*Gilmore,* (S Ct 1963) 11 AFTR 2d 758)

In *Gilmore*, in a divorce proceeding, the taxpayer's then wife was claiming a more-than one-half interest in the taxpayer's controlling stock holdings in three franchised General Motors dealerships as her community property. The taxpayer fought her claims because the loss of his controlling stock interest to his hostile wife might cause him to lose his job as the corporations' president and general manager, and because there was a danger that his wife's sensational and reputation-damaging charges of marital infidelity might cause GM to cancel his dealer franchise. The Supreme Court ruled that the tax character of the costs of resisting a claim depended on whether or not the claim arises in connection with the taxpayer's profit-seeking activities. It did not depend on the consequences that might result to a taxpayer's income-producing property from a failure to defeat the claim. Because the origin and character of the taxpayer's claim were personal, his legal expenses were not deductible.

In *Test,* the taxpayer pursued legal claims related to her employment with the University of California (University) as director of the Center of Prehospital Research and Training in part because she feared harm to her reputation which, in turn, would harm a business, Save-a-Life Systems (SLS), that she operated independent of her position at the University. While she was launching SLS, the taxpayer's University department became the subject of a State audit. The taxpayer retained counsel to respond to negative publicity and attempt to prevent the public release of the draft of the audit report, among other things. The taxpayer claimed that she did so primarily to maintain her professional reputation which was important to the success of SLS. The Tax Court held that it had to look to the origin of the claim and that the taxpayer's motives were not relevant. Because the claim originated in her employment at the University, not with her operation of SLS, the legal fees could not be claimed as business deductions on Schedule C (Profit or Loss From Business), but rather were properly claimed as miscellaneous itemized deductions. (*Test,* TC Memo 2000-362, aff'd (CA 9 2002) 90 AFTR 2d 2002-6596)

Unlike business expense deductions under §162(a), miscellaneous itemized deductions under §67(a) are allowed only to the extent that they, in the aggregate, exceed 2% of adjusted gross income (AGI).

In 2008, Seattle Bank hired Ellen Sas as president and chief executive officer. On or around July 9, 2010, Ms. Sas received a "change of control" bonus of $612,000. Ms. Sas and Rodger Jones (the taxpayers) reported the bonus as wage income on their 2010 tax return.

On September 14, 2010, Seattle Bank terminated Ms. Sas' employment. On November 3, 2010, Seattle Bank filed a complaint against her alleging breach of fiduciary duty and attempted to recover the $612,000 bonus. Ms. Sas counterclaimed, alleging employment discrimination.

All parties involved signed a settlement agreement and mutual releases effective May 17, 2011. The settlement agreement and mutual releases provided that Seattle Bank and Ms. Sas each paid nothing and released and dismissed all claims against each other. The taxpayers paid $25,000 and $55,798 in legal expenses associated with this lawsuit in 2010 and 2011, respectively.

During 2010 and 2011, the taxpayers maintained an accounting and consulting business. They filed a Schedule C with their 2010 Form 1040, reporting Mr. Jones as the sole proprietor. For 2011, the taxpayers reported no income on Schedule C and $293,385 on Schedule E (Supplemental Income and Loss). On the taxpayers' returns for 2010 and 2011, they reported "other income" in the negative amounts of $25,000 and $55,798, respectively, for the legal fees paid for the lawsuit with Seattle Bank.

On audit, IRS disallowed these expenses as negative "other income," but allowed them as miscellaneous itemized deductions subject to the limitation in §67(a), reducing the deductible amounts to $4,525 and $50,579 for 2010 and 2011, respectively. The taxpayers sought relief in the Tax Court.

The taxpayers argued that the legal fees were deductible under §62(a)(20) as legal fees paid in connection with an action involving a claim of unlawful discrimination.

Alternatively, they argued that the legal fees were deductible under §62(a)(1) and §162 as ordinary and necessary business expenses. The taxpayers did not argue that Ms. Sas' claim was rooted in their accounting business; rather, they argued that the lawsuit would have an adverse effect on Ms. Sas' professional reputation which in turn could damage the reputation of their accounting business. Accordingly, the taxpayers contended that the legal fees were necessary expenses of their business.

The Tax Court held that the $25,000 and $55,798 amounts that the taxpayers deducted as legal fees for 2010 and 2011, respectively, should have been claimed as miscellaneous itemized deductions subject to limitation under §67(a).

The Court rejected the taxpayers' attempt to fit their claimed deductions within the limitation under §62(a)(20) -which provides that it does not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the tax year on account of a judgment or settlement resulting from such claim. The taxpayers argued that Ms. Sas included the bonus as income when it was received and was able to retain it because of her counterclaims. Therefore, they reasoned, Ms. Sas' bonus was included in the taxpayers' gross income on account of a judgment or settlement relating to her action. However, the Court concluded that, contrary to taxpayers' view, the "amount includible in the taxpayer's gross income" cannot reasonably be interpreted to include prevention of potential loss of income that would be includible in the absence of any claim. Ms. Sas' bonus was received and includible in the taxpayers' gross income because of her employment with Seattle

Bank. Under the settlement agreement between Ms. Sas and Seattle Bank, neither party received any amount includible in gross income.

Assuming for argument's sake that Ms. Sas' counterclaims were in connection with unlawful discrimination, Ms. Sas did not receive, and the taxpayers did not include in gross income for 2010 or 2011, any amount because of the settlement of her claims. Because the entire amount of the taxpayers' legal fees was in excess of the amount includible in their gross income for the tax year on account of the settlement, the taxpayers could not deduct any of the legal fees under §62(a)(20).

While the Tax Court acknowledged that the taxpayers may have been right that the clawback of Ms. Sas' bonus could harm her professional reputation and in turn the taxpayers' accounting business, the Court concluded that it had to look to the origin of the claim, not the potential consequences of a win or loss. The Court found that Ms. Sas' claims arose from her status as a former employee of Seattle Bank, not from the taxpayers' accounting business, and the taxpayers hired an attorney because Seattle Bank was attempting to claw back a bonus Ms. Sas received in connection with her employment at Seattle Bank. Accordingly, the taxpayers were not permitted to deduct the legal fees as ordinary and necessary expenses of their business under §162.

Schaeffler, et al v. U.S., (DC TX 4/25/17) 119 AFTR 2d ¶2017-692.

A district court has dismissed a refund complaint as untimely brought after the 3-year limitations period under §6511(a), rejecting the taxpayers' assertion that their claim was subject to the 10-year period for overpayments relating to foreign tax credits. The court found that, while there were foreign tax credit adjustments for the year at issue that affected the amount of the total overpayment, the overpayment itself was not generated by those foreign tax credits but rather was attributable to a minimum tax credit carryforward from the prior year.

Taxpayers must file a refund claim with IRS within the period stated in the Code. Under §6511(a), a claim for credit or refund of an overpayment must generally be filed within three years from the time the return was filed or two years from the time the tax was paid, whichever period expires later. No claim for a refund is allowed unless it is filed within these time limits. (§6511(b))

However, under §6511(d)(3)(A), the limitations period is 10 years for claims for refund or credit that relate to overpayments attributable to the payment or accrual to a foreign country or U.S. possession of taxes for which a credit is allowed against U.S. income under §901 (i.e., foreign tax credit), instead of the 3-year period under §6511(a).

Both the U.S. and foreign countries may tax the foreign source income of U.S. taxpayers. To ease this double taxation burden, the Code permits most U.S. taxpayers who pay income taxes to a foreign country to either deduct the taxes from gross income for U.S. purposes or credit them dollar for dollar against their U.S. income tax liability on foreign source income. (§901)

The AMT is separate from, and in addition to, the regular income tax. The purpose of the AMT is to ensure that no taxpayer with substantial economic income avoids a significant tax liability by using exclusions, deductions, and credits. AMT is applied to an expanded income base known as alternative minimum taxable income. (§55(b)(2)) If a taxpayer's tentative minimum tax is more than the regular income tax, the taxpayer pays the difference as AMT. (§55)

A taxpayer who pays AMT is entitled to use some or all of that amount as a credit against regular income tax, referred to as the "minimum tax credit." (§53(a)) The minimum tax credit for a given tax year is limited to the excess of the taxpayer's regular tax liability, reduced by the sum of certain allowed credits, over the taxpayer's tentative minimum tax liability for that year. (§53(c)) It can be applied to reduce regular income tax, and is considered used up, or "absorbed," to the extent that regular income tax exceeds the tentative minimum tax for that year. Unabsorbed minimum tax credits can be carried forward indefinitely to future tax years; if a taxpayer does not use all of the credit in one year, the credit may be aggregated with other credits carried forward and used to reduce future tax liabilities.

Georg Schaeffler and Bernadette Schaeffler, while still married, filed a joint 2001 income tax return in October 15, 2002. On or about April 7, 2012, they filed an amended income tax return for the 2001 tax year in which they alleged that they made an additional payment of tax to Germany for 2001, which resulted in additional foreign tax credits and subjected them to AMT. They claim that these changes did not actually alter their tax liability for 2001 because the AMT increase was offset by an increase in foreign tax credits. However, the taxpayers claimed that the AMT increase was then eligible to be carried forward to future years as a minimum tax credit against future liabilities, and that the foreign tax credits offset minimum tax credits that had previously been absorbed in 2001, with the overall result that $6.8 million in minimum tax credit was carried forward to 2002.

The Schaefflers also filed an amended return for 2002 on or around April 22, 2013, in which they alleged a number of changes to their foreign tax liabilities which resulted in a reduction in eligible foreign tax credits of $1.5 million, and they also applied the $6.8 million minimum tax credit described above. The cumulative effect of these amendments, they claim, resulted in a net overpayment of $5.3 million.

The Schaefflers claimed that the refund claim was timely under the extended 10-year limitations period for refund claims relating to foreign tax credits. (§6511(d)(3))

The court found that the taxpayers' refund claim was not "attributable to any taxes paid or accrued to any foreign country" eligible for a foreign tax credit and was therefore subject to, and barred by, the regular 3-year limitations period under §6511(a).

In so holding, the court found that the taxpayers' refund was not attributable to foreign tax credits. In their amended 2002 return, the adjustments the taxpayers made actually reduced their overall foreign tax credits, which alone would have resulted in a net underpayment for that year. Rather, the overpayment for 2002 resulted from their increased minimum tax credit carried forward from their amended 2001 return. The court reasoned that the phrase "attributable to" should be afforded its plain meaning-i.e., "due to, caused by, or generated by" (*Electrolux Holdings, Inc. v. U.S.,* (CA Fed Cir 2007) 99 AFTR 2d 2007-3390) and that, applying that interpretation, the refund here was not "attributable to" foreign tax credits.

The taxpayers generally argued for a broad construction of the phrase "attributable to," such that something could be attributable to more than one cause, citing as support the Supreme Court's decision in *U.S. v. Woods,* (S Ct 2013) 112 AFTR 2d 2013-6974. That decision held that the penalty for tax underpayments "attributable to" valuation misstatements under §6662(b)(3) was applicable to an underpayment that resulted from a basis-inflating transaction that was later disregarded for lack of economic substance. However, the district court found that nothing in Woods indicates that "attributable to" is to be used in any way other than its plain meaning.

The taxpayers also argued that, under *First Chicago Corporation v. Commissioner,* (CA 7 1984) 54 AFTR 2d 84-5957, the minimum tax credit carryforward was an "automatic mechanical adjustment" that was inseparably related to the 2002 foreign tax redeterminations. However, the court rejected this argument, finding that without the minimum tax credit carryforward, there would have been no overpayment, so it was not an "automatic mechanical adjustment" that was directly due to the 2002 foreign tax credit readjustments. Even though those adjustments affected the amount of the total overpayment, the overpayment was still due to the minimum tax credit.

Accordingly, the court found that the taxpayers' refund claim was not timely under §6511 and therefore barred, and the case was dismissed for lack of jurisdiction.

Schieber, TC Memo 2017-32.

Taxpayer's interest in his employer's defined benefit pension plan, with respect to which his only right was to receive monthly payments, was not an asset for purposes of determining whether he was insolvent under §108 's exclusion for cancellation of debt income (CODI) for insolvent taxpayers.

§61(a)(12) provides that gross income includes income from the cancellation of a debt. There are, however, exceptions under which a taxpayer may not be required to include such CODI in gross income. One such exception is in §108(a)(1)(B), which excludes from gross income any amount that would otherwise be includable by reason of the cancellation of the taxpayer's debt, in whole or in part, if the cancellation occurs when the taxpayer is insolvent. §108(a)(3) provides that the amount of income excluded under §108(a)(1)(B) "shall not exceed the amount by which the taxpayer is insolvent." The term "insolvent" is defined by §108(d)(3) as "the excess of liabilities over the fair market value of assets."

The taxpayers, Mr. and Mrs. Schieber, were a married couple. In 2009, Mr. Schieber's mortgage debt was cancelled. During that year, Mr. Schieber was retired and was receiving monthly payments under a defined benefit pension plan. In the event of Mr. Schieber's death, Mrs. Schieber had a right to receive the monthly payments. Other than the right to receive the monthly payments, the Schiebers could not access the value in the plan. They could not convert their interest in the plan to a lump-sum cash amount, sell the interest, assign the interest, borrow against the interest, or borrow from the plan.

The Court held that Mr. Schieber's interest in the pension was not an asset for purposes of determining whether the Schiebers were insolvent.

IRS contended the Schiebers' interest in the pension plan should be considered an asset because they could use their monthly payments to pay liabilities.

But the Court disagreed. It looked to the facts in *Carlson,* (2001) 116 TC 87, which noted that the word "asset" is not defined in the Code. The Carlson Court held that an asset exempt from creditors could still be an asset under §108(d)(3) because even an asset exempt from creditors can give the taxpayer "the ability to pay an immediate tax on income" from the canceled debt. That Court held that a commercial fishing license could be an asset because the license could be used, in combination with other assets, to immediately pay the income tax on canceled-debt income.

The Court here said that the test in Carlson is whether the asset gives the taxpayer the ability to pay an "immediate tax on income" from the canceled debt-not the ability to pay the tax gradually over time. In contrast to Carlson, the Schiebers could not use their interest in the pension plan to immediately pay a tax liability because they were entitled only to monthly payments under the plan and could not convert their interest in the plan to a lump-sum cash amount, sell the interest, assign the interest, borrow against the interest, or borrow from the plan.

Sensenig, TC Memo 2017-1.

Where a taxpayer made large investments in start-up businesses that the parties called loans, there was very little other equity in those businesses, and there were no loan agreements or demand for repayment, the investments were equity and not debt. The Court also held that the investments were not worthless in the year at issue.

A taxpayer is entitled to a deduction for any bona fide debt that becomes worthless within the tax year. (§166(a)(1)) A bona fide debt arises from "a debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable sum of money." (Regulation §1.166-1(c)) By definition, a capital contribution is not a debt for purposes of §166. (Regulation §1.166-1(c))

§385 addresses whether an interest in a corporation is debt or equity. §385(b) authorizes IRS to prescribe regulations setting forth factors to be taken into account in resolving the issue, and it provides five factors that "the regulations may include," the first of which is "whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest." (§385(b)(1))

In 2016, IRS issued final debt vs. equity regulations, that are effective for instruments issued on or after January 1, 2018 (see T.D. 9790, 10/13/2016).

Mr. Sensenig, a resident of Pennsylvania, was the sole shareholder and president of CLCL, an S corporation. CLCL provided high-risk capital to various companies. CLCL obtained the money that it invested (the investor pool) as a result of Sensenig soliciting investments in the CLCL financing activity by other Mennonite and Amish individuals. The investors were promised attractive rates of return by demand notes payable by Sensenig individually or by CLCL. Sensenig did not obtain any third-party audits or request any financial statements with respect to the companies in which CLCL invested, and CLCL did not finance any company if that company had other means to borrow, such as traditional banking.

Three of the companies that CLCL invested in were G-L, LFP, and WSC (the Borrowers). Sensenig also owned an equity interest in each of the Borrowers, and the Borrowers had very little other equity. No loan documents were created for the advances to the Borrowers, and Sensenig never attempted to collect repayment of the advances.

The Pennsylvania Securities Commission (PSC) investigated Sensenig's receipt of funds borrowed from his investors. The PSC determined that Sensenig's practice of issuing demand notes to investors in return for receipt of borrowed funds constituted the sale of unregistered securities. In June 2005 Sensenig and CLCL received from the PSC an order to cease and desist the offering and sale of unregistered securities. As a result, Sensenig was barred from accepting any more money into the investor pool, and he lacked funds to advance to the not-yet-completed projects from which he had expected eventually to pay off the demand notes. He perceived this as a dire threat to CLCL, its investors, and its investments.

In January 2006, the PSC accepted Sensenig's offer of settlement and rescinded the order to cease and desist. Sensenig and CLCL were permanently barred from offering or selling securities in Pennsylvania unless he received a valid registration statement. He never obtained such a statement.

By the end of 2005, it appeared to both the Borrowers and Sensenig that the successes that each of the Borrowers had anticipated were not likely to come about. Sensenig claimed bad debt deductions totaling almost $11 million on CLCL's Form 2005 1120S for its loans to the Borrowers. But, each of the Borrowers was still operating after 2005, and for several years CLCL continued to advance money to each of the Borrowers. For example, G-L's records reflected that in 2006 CLCL advanced it $800,000, that in 2007 CLCL advanced another $950,000, and that in 2008 CLCL advanced an additional $1 million.

IRS disallowed the bad debt deductions in their entirety.

Observation: Thus, because of the year at issue, 2005, the debt vs. equity regulations discussed above do not apply to this case.

The Court concluded that the investments were equity, not debt.

The Court, citing *Fin Hay Realty Co.,* (CA 3 1968) 22 AFTR 2d 5004, said there were three factors to consider: (1) the intent of the parties; (2) the form of the instrument; and (3) the objective economic reality of the transaction as it relates to the risks taken by investors.

As to intent, Sensenig testified that there was an understanding between the parties that "the borrower will post it as borrowed money, and the lender will post it as money loaned out." And consistent with that, Sensenig offered CLCL journal entries that labeled some advances as loans.

However, for only one of the companies at issue, WSC, did Sensenig provide shareholders' and directors' resolutions authorizing WSC to borrow from CLCL; and even in that instance, there was no further documentation to demonstrate that thereafter the authority was actually exercised and a loan was made to WSC, or that WSC had an obligation to repay such a loan. And, apart from Sensenig's testimony and the journal entries of CLCL, there was no evidence that reflected that CLCL or any of the companies at issue treated the monetary advances from CLCL as draws on lines of credit.

As to form, the Court said the investment had little or no form. There was no loan agreement providing for repayment of CLCL's advances; there was, in fact, no written agreement of any sort; and Sensenig never made any formal demands for repayment. The Court said, citing *Scriptomatic* Inc., (DC PA 1975) 36 AFTR 2d 75-5422, that absence of an unconditional right to demand payment is practically conclusive that an advance is an equity investment.

The Court also noted, in this regard, that Sensenig was not a financially unsophisticated person unaccustomed to having written agreements. On the contrary, his arrangements with those who invested in CLCL's investor pool were duly reflected in demand notes that stated rates of interest.

As to economic reality, the Court, citing Fin Hay, said that the acid test of the economic reality of a purported debt is whether an unrelated outside party would have advanced funds under like circumstances.

In concluding that Sensenig failed this test as well, the Court said that the companies Sensenig chose to finance were start-up ventures that could not obtain financing from unrelated banks. As a matter of CLCL policy, if a start-up company had other sources or means to borrow, CLCL would not advance money to it. (And other than the money that CLCL provided to the companies, very little in the way of capital contributions were made by anyone else.) The Borrowers were objectively risky debtors, and an unrelated prospective lender would probably have concluded that they would likely be unable to repay any proposed loan.

With respect to the advances at issue here, Sensenig generated no formal written financial projections and did not know what those projections would be. He was satisfied to go with the "gut feel of everybody involved." He considered business plans a waste of time and emphasized the importance of being able to "turn on a dime" on the basis of the facts of the moment, unconstrained by any formal plan. The Court said that an unrelated lender would have considered this approach too cavalier.

When Sensenig decided to write off the advances, it was because he believed the possibility the companies would be profitable was remote. And yet CLCL continued to provide financing (of approximately $9 million) to all three companies after the year for which the bad debt deduction was claimed. No prudent lender would have continued to advance money to any of these companies under such circumstances.

And, the Court concluded that Sensenig did not carry his burden to prove that any debts were worthless in 2005. He put on no evidence as to the financial condition of the three borrower companies as of December 31, 2005. The Court accepted that the 2005 cease-and-desist order was a major harmful event for CLCL and the companies in which it invested; but whether and when that event caused worthlessness was not demonstrated.

As a result, the Court sustained IRS's disallowance of the bad debt deductions.

Silipigno, (DC NY 7/13/2017) 120 AFTR 2d ¶ 2017-5046.

A district court has disallowed two separate net operating loss (NOL) carrybacks (CBs) of a taxpayer. In the case of the first NOL CB, the taxpayer was deemed to have failed to have filed a refund claim, and, as a result, the court did not have jurisdiction to hear the NOL CB issue. The other NOL CB was disallowed because the taxpayer provided insufficient documentation of expenses in both the loss year and the carryback year.

A taxpayer must file a timely refund claim with IRS before bringing a refund suit. (§7422(a))

"In general, in the case of an overpayment of income taxes, a claim for credit or refund...shall be made on the appropriate income tax return." Where the taxpayer is seeking a refund of individual income tax, "a claim for refund shall be made on a Form 1040X (Amended U.S. Individual Income Tax Return)." (Regulation §301.6402-3(a)(1))

A taxpayer may file an application for a tentative carryback adjustment of the tax for an earlier tax year affected by an NOL carryback under §172(b). (§6411(a)) Individuals, estates and trusts use Form 1045 (Application for Tentative Refund) to claim a tentative refund. (Regulation §1.6411-1(b)(1))

Within 90 days from the date on which an application for a tentative carryback adjustment is filed...IRS is to make, to the extent it deems practicable in such period, a limited examination of the application. (§6411(b))

Form 1045 "shall not constitute a claim for credit or refund" as required by §7422(a). (§6411(a))

Observation: A tentative refund application generally will result in the taxpayer receiving the refund moneys sooner than if he had filed a regular refund claim.

While a refund claim is typically filed on an official IRS form, an informal claim may be recognized if it: (1) is timely; (2) asserts a right to a refund; (3) describes the tax, tax year, and basis for the claim; and (4) has some written component. (*Pala Inc. Employees Profit Sharing Plan and Trust Agreement,* (CA 5 2000) 86 AFTR 2d 2000-7079) The informal claim must put IRS on actual or constructive notice that the taxpayer is currently asserting a right to a refund. (*Mobil Corp v. U.S.,* (Ct Fed Cl 2005) 96 AFTR 2d 2005-6230)

In *Lewis v. Reynolds* (S Ct 1932), 10 AFTR 773, the Supreme Court concluded that the ultimate question in a refund case is whether the taxpayer has overpaid his tax and that answering that question involves a redetermination of the entire tax liability. While no new assessment can be made after the statute of limitations has run, the taxpayer is not entitled to a refund unless he has overpaid his tax. Thus, even when IRS may not collect a deficiency, it may retain payments already received when they do not exceed the amount which would have been properly assessed and demanded were it not for the statute of limitations.

In February 2008, IRS commenced an audit of the 2005 tax return of the taxpayer, Mr. Silipigno.

In 2009, the United States Attorney's Office (USAO) initiated a criminal investigation into mortgage, bank, and tax fraud with respect to Silipigno. On June 9, 2009, the USAO, with the assistance of agents from IRS and the Federal Bureau of Investigation, executed a search warrant of Silipigno's office and the office of Mr. Gilooly, Silipigno's accountant. The agents seized hundreds of boxes of documents, computers, servers, and other items belonging to Silipigno.

On September 8, 2009, IRS suspended the audit to await the completion of the criminal investigation. In 2014, after the USAO declined to prosecute Silipigno, the 2005 IRS audit recommenced.

In October 2010, Silipigno filed his 2007 return claiming an NOL. He also timely filed an Amended U.S. Individual Income Tax Return (Form 1040X) on October 15, 2010, seeking a refund of $509,752 from his 2005 taxes attributable to his 2007 NOL.

Silipigno filed his 2009 return on October 15, 2010, claiming an NOL. He also timely filed an Application for Tentative Refund (Form 1045) on October 15, 2010, seeking a refund of $806,586 from his 2004 taxes attributable to his 2009 NOL. This Form 1045 was the only document submitted by Silipigno to IRS that sought a refund of income taxes for the 2004 tax year.

When IRS did not act on his NOL CBs, Silipigno brought this refund case.

Noting that it was undisputed that Silipigno did not comply with Regulation §301.6402-3(a)(2) by filing a Form 1040X for the 2004 tax year with respect to the 2009 NOL carryback, the court rejected several arguments by Silipigno and disallowed the 2009 carryback.

Silipigno argued that his Form 1045, "coupled with additional written and oral submissions to IRS," constituted a timely informal claim that satisfied the jurisdictional requirement of §7422(a).

The court disagreed and said that numerous courts have held that an application for tentative refund does not constitute an informal claim for purposes of satisfying §7422 's administrative exhaustion requirement. "The argument that an application for a tentative carryback adjustment may constitute an informal claim, if accepted, would not only contradict the plain meaning of the relevant regulations...but would obliterate the distinction between a tentative application and a formal claim for a refund." The court also said that "given the clarity of the statutory language and this case law," it would not even consider Silipigno's Form 1045 in its analysis of whether he filed a timely informal claim.

And, it said that Silipigno did not present any evidence that he submitted relevant written correspondence (other than the Form 1045) to IRS between the date he filed his Form 1040 for the 2009 tax year and the date after which a claim for refund attributable to the 2009 NOL was time-barred. Silipigno's correspondence with IRS after he brought this case was irrelevant because it occurred after the statute of limitations on his refund claim had run. There was no indication in the communication between IRS and Silipigno that IRS was aware of "the legal and factual basis" for Silipigno's refund claim before the filing of his complaint or the running of the statute of limitations.

Silipigno argued that IRS did not provide "notice and a timely opportunity to file a Form 1040X," because it did not respond to his Form 1045. The court noted that, under §6411(b), IRS need not make its "limited examination" at all except "to the extent [it] deems practicable" within the 90 days. It was not necessary for Silipigno to await action by IRS on its application for tentative carryback adjustment to file a claim for refund. Such claim could have been filed at any time without regard to action or lack of action on the tentative carryback application.

The court then disallowed the 2007 NOL CB because Silipigno did not substantiate deductions that IRS challenged, on both the 2007 return and 2005 return.

Silipigno first argued that his burden of proof regarding deductions did not apply to the income taxes he paid for the 2005 tax year, because IRS could no longer assess previously undiscovered deficiencies against him regarding his 2005 income taxes due to the expiration of the relevant statute of limitations. But the court said that, under the principles of Lewis v. Reynolds, IRS is permitted to reduce the amount of the taxpayer's refund by the correct tax for the year, even if IRS can no longer assess the amount of any deficiency it may have determined to be due. Therefore, Silipigno bore the burden of proof that the taxes he paid in 2005 and the loss he claimed in 2007 were correct.

In court, IRS raised two deficiencies with regard to Silipigno's 2007 and 2005 tax returns: (1) the inclusion of $4,510,050 in expenses for "cost of goods sold" on Silipigno's 2005 Schedule C for his mortgage consultancy business, and (2) the loss of Silipigno's $2,129,876 investment in a limited liability company on his 2007 return.

The court concluded that Silipigno did not submit any records to justify the claimed cost of goods sold or why he was entitled to include such expenses on his personal tax return.

Silipigno's record keeping was clearly complicated by the fact that federal investigators seized thousands of records on June 9, 2009. But the court said that he did not present an argument as to the relevance of that fact, and it noted that equitable considerations will not affect a taxpayer's burden except in the most extraordinary circumstances. Silipigno did not attempt to show that his experience was extraordinary or even to delineate what documents might have been lost in the 2009 raid, which might justify their absence from the record. In addition, Silipigno failed to produce records during the initial phase of the IRS audit in 2008, more than a year prior to the raid, when asked for documentation to support these expenses.

The court said that, while it was sympathetic to the large number of years over which the investigation spanned, Silipigno was not excused from his responsibility to maintain sufficient records to justify his returns. Given the complete lack of records submitted in support of Silipigno's 2005 "cost of goods" expenses, no reasonable jury could find that Silipigno was entitled to subtract these expenses from his business income.

Therefore, Silipigno's 2005 income taxes were under-reported based on the inclusion of $4,510,050 in cost-of-goods expenses on his Schedule C for his mortgage consultancy business. Although IRS was time barred from assessing this deficiency, the cost of goods sold adjustment could be and was used by the court to fully offset any refund to which Silipigno was entitled.

Smiling, TC Memo 2017-196

The Tax Court has held that, where a divorce attorney engaged in a series of transactions with his client that the divorce court deemed to be attempts to hide some of the client's assets, and the divorce court awarded the client's husband a claim of right against the attorney, payments made by the attorney to the husband were not deductible business expenses. The Court also made rulings with respect to the application of the negligence penalty to those payments and to other deductions taken by the attorney.

Under §162 , taxpayers generally can, subject to certain limitations, deduct "ordinary" and "necessary" expenses paid or incurred during the tax year in carrying on any trade or business. An amount paid for protection of one's professional reputation can be an ordinary and necessary expense. (*Milbank,* (1969) 51 TC 805)

Under §6664(c)(1) , an accuracy-related penalty under §6662 will generally not apply to any portion of an underpayment if it is shown that there was reasonable cause for that portion and that the taxpayer acted in good faith. Reasonable cause requires that the taxpayer exercise ordinary business care and prudence as to the disputed item. (*Neonatology Associates*, (2000) 115 TC 43 , aff'd (CA 3 2002) 90 AFTR 2d 2002-5442) Good faith means, among other things, an honest belief and an intent to perform all lawful obligations. (*Hirschfeld,* (CA 4 1992) 70 AFTR 2d 92-5697)

The Supreme Court recognized that a taxpayer exercises "[o]rdinary business care and prudence" when he reasonably relies on a professional's advice on matters beyond the taxpayer's understanding. Further, a taxpayer need not challenge an independent and qualified adviser, seek a second opinion, or monitor advice on the provisions of the Code. (*U.S. v. Boyle*, (S Ct 1985) 55 AFTR 2d 85-1535)

A taxpayer claiming reliance on a tax professional must prove that: (1) the adviser was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer provided necessary and accurate information to the adviser; and (3) the taxpayer actually relied in good faith on the adviser's judgment. (*Neonatology*)

The taxpayer, Mr. Smiling, was an attorney who represented Dr. Moon in her divorce case with her husband, Dr. Lewis.
Mr. Smiling and Dr. Moon engaged in a number of transactions in which Dr. Moon gave Mr. Smiling large sums of money. Mr. Smiling put the money into his lawyer trust account initially but later did various other things with the money including investing it in a new business that he owned. At one point he signed a promissory note payable to his lawyers trust fund account for the monies that he took out of it. Collectively, Mr. Smiling received $1.4 million from Dr. Moon.

After receiving these amounts from Dr. Moon, Mr. Smiling completed and signed a life insurance change of beneficiary form naming Dr. Moon as the beneficiary of his $1.4 million policy. Mr. Smiling and Dr. Moon also executed a document pursuant to which Mr. Smiling promised to repay a loan of $1.1 million over the course of five years. That document was accompanied by a mortgage collateralized by property owned by Mr. Smiling.

As part of the order of divorce, the divorce court awarded to Dr. Lewis any and all rights or claims to recover funds deposited by Dr. Moon with Mr. Smiling. The divorce court noted that Mr. Smiling had testified that he did not owe anything to Dr. Moon. The divorces court said "Dr. Lewis should be permitted to test that assertion."

Thereafter, Mr. Smiling entered into a settlement agreement with Dr. Lewis, under which Mr. Smiling paid Dr. Lewis $500,000 to release all claims that Dr. Lewis had against Mr. Smiling.

In preparation of his Form 1040, Mr. Smiling gave his accountant copies of the checks he wrote to Dr. Lewis, telling his accountant only that the amounts were for the "protection of the reputation and integrity of the law business." The facts relating to Drs. Lewis and Moon were not shared with the accountant. The accountant concluded that the settlement expenses were deductible as ordinary and necessary business expenses of Mr. Smiling's business as an attorney.

At some point, a complaint was filed against Mr. Smiling with the Oklahoma Bar Association. Mr. Smiling hired an attorney to represent him before the bar association. As a result of the services rendered by Mr. Smiling's attorney, Mr. Smiling received invoices, and he made payments with respect to those invoices. Mr. Smiling showed those checks to his accountant, who took Form 1040 deductions for the amounts, but the canceled checks are not part of the court record.

In its notice of deficiency, IRS disallowed deductions for the payments to Dr. Lewis and for the legal fees. It also sought negligence penalties with respect to the deductions for both of those types of payments.

The Court disallowed the deduction for the payments that Mr. Smiling made to Dr. Lewis; it reasoned that they were merely a repayment of Dr. Moon's funds that had been received by Mr. Smiling.

Mr. Smiling argued that the settlement payments were made to protect his professional reputation and his ability to represent some of his current clients, in light of the possible allegation that he had incorrectly used his client trust fund account.

He also argued that he did not owe Dr. Moon any money, i.e., that he had already repaid her previously. As to the insurance policy and the loan document and mortgage, Mr. Smiling "suggested that these documents were merely pro forma...They were mock documents not intended to be enforceable."

The Court found Mr. Smiling's explanations to not be credible, particularly in light of the content of the divorce court order. The Court also mentioned, in support of its decision, the fact that the dollar amounts involved with the insurance policy and the document reflecting a loan from Dr. Moon were so similar to the $1.4 million that Mr. Smiling acknowledged that he had received at some point from Dr. Moon.

The Court also denied Mr. Smiling's deduction for legal expenses because he didn't provide the Court with any support for the amount that he deducted.

The Court found that the negligence penalty applied with respect to Mr. Smiling's deduction for his payments to Dr. Lewis but did not apply to his deduction for the legal expenses.

Mr. Smiling did not provide to his accountant any documents or information relating to Dr. Moon's money; he did not discuss the insurance policy or the mortgage; and he did not discuss Dr. Moon's divorce proceedings. And there was no evidence that Smiling's accountant discussed the impact of these types of facts upon the deductibility of the claimed settlement expense deduction. Accordingly, the Court concluded that Mr. Smiling failed to show that he provided the accountant with necessary and accurate information.

As to Mr. Smiling's deduction for legal expenses, the Court said that it was clear that a complaint was filed against Mr. Smiling with the Oklahoma Bar Association. Mr. Smiling retained counsel, and the canceled checks for the attorney's fees were provided to Mr. Smiling's accountant. Although Mr. Smiling failed to substantiate to the Court the amounts paid, his credible testimony on this point - combined with the credible testimony of his accountant and the affidavit of Mr. Smiling's attorney - convinced the Court that at the time he filed his Form 1040, he had reasonable cause and good faith for the legal and professional services expense deduction claimed. Therefore the negligence penalty did not apply to the portion of his underpayment attributable to the legal expenses.

Smyth, TC Memo 2017-29.

The Tax Court, reaching a result that it said was impossible to describe as "in any way just," held that a taxpayer's grandchildren were not "qualifying children" for tax purposes, despite the facts that she provided all of their financial support and had initially been told by her son that she should claim them as her dependents. The Court found that the son actually claimed the children on his return as dependents in order to fund his drug habit and that, although he later prepared an amended return attempting to relinquish that claim and delivered it to IRS counsel, the attempt was ineffective because the return was never filed.

There are a number of tax benefits that a taxpayer can potentially claim in respect to a "qualified child," including, among others, head-of-household filing status under §2(b), a dependency exemption under §151(c), a child tax credit under §24(a), and an earned income credit under §32(b). Qualification for, and the amount of, these benefits are based in part on the number of "qualifying children."

A "qualifying child" of a taxpayer is an individual who: (A) bears a certain relationship to the taxpayer, including being a child or grandchild of the taxpayer, (B) has the same principal place of abode as the taxpayer for more than one-half of the tax year, (C) is less than 19 years old, (D) has not provided over one-half of his or her own support for the calendar year, and (E) does not file a joint return. (§152(c))

If two or more taxpayers can claim an individual as a qualifying child for a tax year beginning in the same calendar year, then the individual is treated under the so-called "tie-breaker rules" as the qualifying child of the taxpayer who is (i) the parent, or if (i) does not apply, (ii) the taxpayer with the highest adjusted gross income for that tax year. (§152(c)(4))

Grisel Smyth is a certified nursing assistant. For all of 2012, her adult son, his wife, and their two young children, who were then two and four years old, lived with Smyth in her home. She provided all the financial support for the household because her son "did not work, and he was into dealing drugs" while his wife "stayed home and took care of the babies."

Smyth timely filed her 2012 income tax return claiming the two grandchildren as her dependents after her son told her that he and his wife were not going to file and that she should try to get back some of the money she had spent supporting his family. In February 2014, Smyth received a deficiency notice that increased her tax by more than $5,000 on the basis that the grandchildren were not her "qualifying children." After some initial confusion, Smyth's son admitted that he and his wife filed a return claiming dependency exemption deductions for their children so that he could get a refund and buy drugs.

Smyth's son offered to write an affidavit in support of her position and prepared an amended 2012 return that deleted his claim that his children were his dependents. A copy of this amended return was given to IRS's counsel two weeks before trial.

IRS argued that Smyth is not allowed to claim her grandchildren because, under the tie-breaker rules, their parents get to claim them. Smyth, however, argued that her son and his wife never filed an "original return"; and, even if they did, they filed an amended return before trial in which they released any claim they had to claim the children as their "qualifying children."

The Tax Court ruled that, although the grandchildren were "qualifying children" of Smyth who satisfied the §152(c) requirements, the parents, and not Smyth, get to claim them under the tie-breaker rules.

The Court found that there was little evidence to support Smyth's argument that her son and his wife did not file an original 2012 return. While the Court believed her statement that she did not know that they had filed a return claiming the children as their "qualifying children," and that she would not have claimed them as her qualifying children if she thought they had, it found that this was insufficient to show that "her son did not say one thing and do another."

The Court also found that the son never actually filed an amended return relinquishing their claim. Although they prepared an amended return and had their return preparer deliver it to IRS counsel, this was insufficient to establish filing under §6091. They did not mail the return to the appropriate service center, and they did not hand carry it and turn it over to a person with responsibility to receive hard-carried returns at IRS's office. Under *Quarterman,* TC Memo 2004-241, hand delivery of a return to IRS counsel does not constitute filing. Therefore, since the amended return was not properly filed, it could not be the basis for her assertion that the son and his wife gave up their right to claim their children as "qualified children." Accordingly, the tie-breaker rules applied and the children's parents get to claim them.

The decision that Smyth could not treat the grandchildren as her "qualifying children" in 2012 meant that she could not claim them as dependents, was not entitled to an earned income credit, was not entitled to child tax credits, and could not use head-of-household filing status.

Nonacquiescence to Stanley (DC AK 11/12/2015) 116 AFTR 2d 2015-6766

In IRB 2017-42 published October 16, 2017, IRS has said that it disagrees with and will not follow the district court's decision in Stanley, where the court ruled that for purposes of the real estate professional's exception to the passive activity loss (PAL) rules: (1) restricted stock is counted in the 5% ownership requirement allowing services performed as an employee to be treated as performed in real property trades or businesses; and (2) work performed by the taxpayer in a rental real estate activity may also constitute work performed by the taxpayer in non-rental business activities of the taxpayer.

In general, under the PAL rules of §469, losses from passive activities—activities in which the taxpayer does not materially participate, and most rental activities—may only be used to offset passive activity income. A taxpayer is treated as materially participating in an activity if he meets at least one of the seven tests in Regulation §1.469-5T.

Under certain circumstances, a taxpayer may treat one or more trade or business activities or rental activities as a single activity (e.g., for determining material participation).

In general, under §469(c)(2), a rental activity is per se a passive activity regardless of the taxpayer's participation in the activity. However, under §469(c)(7), the per se rule for rental activities does not apply to a qualifying real estate professional. If a taxpayer is a qualifying real estate professional, the PAL rules generally are applied as if each interest of the taxpayer in real estate were a separate activity. (§469(c)(7)(A)(ii)) For example, the determination of whether the taxpayer materially participates is applied separately to each interest. But, a real estate professional may elect to treat all his interests in rental real estate as one activity. (Regulation §1.469-9(g))

For purposes of determining whether a taxpayer is a real estate professional whose rental real estate activities are not automatically treated as passive activities, personal services performed as an employee aren't treated as performed in real property trades or businesses unless the employee is a 5% owner (as defined in §416(i)(1)(B)) of the employer. (§469(c)(7)(D)(ii))

In the IRB, IRS said that it will not follow the following holdings of the district court in *Stanley vs. U.S.,* (DC AK 11/12/2015) 116 AFTR 2d 2015-6766: (1) mere possession of a stock certificate—disregarding other conditions, restrictions or limitations on the possessor's rights regarding the stock—constitutes ownership for purposes of §469(c)(7)(D)(ii); and (2) work performed by the taxpayer in a rental real estate activity for purposes of §469(c)(7)(A) may also constitute work performed by the taxpayer in non-rental business activities of the taxpayer for other purposes of §469.

Stettner, TC Memo 2017-113.

The Tax Court has held a taxpayer, who had been racing cars for 20 years and had previously attempted to be in the racing business, did not have a profit motive for his new attempt at the business and thus could not deduct his losses.

Under the so-called hobby loss rules, if an activity is not engaged in for profit, deductions generally are disallowed by §183 except to the extent of the gross income derived from the activity for the tax year. To be entitled to business expense deductions without limitation, and avoid being blocked by §183, a taxpayer must show that he engaged in the activity with an actual and honest objective of making a profit. Deductions are not allowable for activities that a taxpayer carries on primarily as a sport, as a hobby, or for recreation. (Regulation §1.183-2(a))

Regulation §1.183-2(b) enumerates nine factors to consider in determining whether a taxpayer has a profit objective. The list is not exhaustive, and no single factor is conclusive. Courts may accord certain factors greater weight than others.

An activity is presumed to be engaged in for profit for a tax year if the activity produces income in excess of deductions for any three of the five consecutive years which end with the tax year, unless IRS establishes to the contrary. (§183(d)) However, if the taxpayer so elects, this presumption will apply to each tax year in the 5-tax-year period beginning with the tax year in which the taxpayer first engages in the activity, if the gross income derived from the activity for three or more of the tax years exceeds the deductions attributable to the activity. (§183(e))

The taxpayers were Allen Stettner and his wife.

In 2006, Mr. Stettner formed Al Stettner Racing. The Stettners reported net losses of $19,991 and $16,641 from Al Stettner Racing on Schedules C, Profit or Loss From Business, for 2006 and 2007, respectively. The Stettners stopped operating Al Stettner Racing in 2007, and they did not report a car racing activity on Schedules C for 2008-10. In 2009, the Stettners filed a chapter 7 bankruptcy petition that, by their own admission, was attributable in part to Al Stettner Racing's losses.

In 2011, Mr. Stettner was unemployed; despite having no formal business education and having incurred substantial losses while operating Al Stettner Racing, Mr. Stettner formed another race business, AJS. He was confident that he could operate AJS for a profit; he believed that nearly 20 years of racing experience, reading periodicals and online resources, and consulting with drivers who were "regularly successful" established the requisite expertise for operating a profitable racing business. Mr. Stettner devoted 40-60 hours per week to AJS while unemployed in 2011 and 15-20 hours per week after he became gainfully employed in 2012.

Mr. Stettner did not have a written business plan for AJS, only a mental one. He also did not have a separate bank account for AJS and instead paid AJS's expenses out of the Stettners' personal checking account.

The Stettners reported net profits and losses from AJS on Schedules C for 2011-15 as follows:

a. 2011: $62,769 loss
b. 2012: $16,016 loss
c. 2013: $3,840 profit
d. 2014: $4,638 profit
e. 2015: $3,158 profit

AJS's gross income was comprised of race prize money, proceeds from sales of used parts and cars, and sponsorship payments.

AJS paid at least $11,000 and $10,000 of expenses for car parts purchased from Fegers Racing for 2013 and 2014, respectively. Both amounts exceeded AJS's total expenses reported on Schedules C for those respective years. Therefore, contrary to AJS's reported net profits on Schedules C for 2013 and 2014, the Court found that AJS had net losses of at least $2,260 and $754 for 2013 and 2014, respectively.

During 2014 and 2015, Mr. Stettner worked as a mechanic for Kremer Services, LLC (Kremer); he purchased tools in connection with his employment at Kremer, the costs of which the Stettners claimed as deductions for unreimbursed employee expenses on Schedules A, Itemized Deductions, of $18,978 and $14,303 for 2014 and 2015, respectively. Mr. Stettner received $18,696 and $36,899 in wages from Kremer for 2014 and 2015, respectively.

The Stettners timely made the §183(e) election. The only year at issue was 2011.

The Court concluded that the Stettners did not have a profit motive and disallowed the 2011 car racing losses.

The Court noted, citing *Smith*, TC Memo 1993-140, that evidence from the years after the year in issue is relevant to the extent it creates inferences regarding the taxpayer's requisite profit objective in earlier years.

The Court said that, because it found that AJS had net losses of at least $2,260 and $754 for 2013 and 2014, respectively, it concluded that AJS did not produce gross income in excess of deductions for three of AJS's first five years, and therefore the Stettners were not entitled to the presumption that AJS was engaged in for profit under §183(d) and §183(e). It also noted that, even had it accepted the Stettners' reported net profits on Schedules C for tax years 2013-15 and thereby found that they were entitled to the presumption under §183(d) and §183(e), there was ample evidence in this case to indicate that petitioners did not engage in AJS for profit.

The Court then looked to the Regulation §1.183-2(b) tests, found that six favored IRS, two favored the Stettners, and one was neutral, and concluded that there was no 2011 profit motive. Here is how the Court ruled with respect to some of the Regulation §1.183-2(b) tests:

a. Manner in which taxpayer conducted the activity. The fact that a taxpayer carries on an activity in a businesslike manner may indicate a profit motive. (Regulation §1.183-2(b)(1)) This determination requires that it consider whether the taxpayer: (1) maintained complete and accurate books and records; (2) conducted the activity in a manner substantially similar to those of other activities of the same nature that were profitable; (3) changed operating methods, adopted new techniques, or abandoned unprofitable methods in a manner consistent with an intent to improve profitability; (Regulation §1.183-2(b)(1)) and (4) prepared a business plan. (Keating, TC Memo 2007-309)

The Stettners did not have a written business plan for AJS, only a mental one. AJS did not have its own bank account, and all of its expenses were paid from the Stettners' personal checking account. Failure to keep adequate books and records and the lack of a written business plan indicated that the Stettners did not conduct AJS in a businesslike manner nor in a manner similar to those of other profitable car racing activities. Further the Stettners did not change operating methods, adopt new techniques, or abandon unprofitable methods that contributed initially to Al Stettner Racing's losses and subsequently to the Stettners' 2009 chapter 7 bankruptcy petition. Accordingly, this factor favored IRS.

b. Expertise of taxpayer or his advisers. Preparation for an activity by the extensive study of its accepted business, economic, and scientific practices, or consultation with those who are experts therein, may indicate a profit motive. (Regulation §1.183-2(b)(2))

Mr. Stettner's car racing experience of 20-plus years was a valuable way to gain expertise in an activity, but the Stettners had not acquired the requisite expertise necessary to conduct a car racing business profitably, as evidenced by both Al Stettner Racing's and AJS's history of losses. Further, the Stettners did not introduce any credible evidence that the "regularly successful" drivers that Mr. Stettner consulted made a profit in car racing or were anything other than mere hobbyists, nor did the Stettners specify which online resources and periodicals he read for research. Conversely, IRS did not convince the Court that the Stettners lacked the requisite expertise to conduct a car racing business profitably. Accordingly, this factor was neutral.

c. Taxpayer's time and effort devoted to the activity. The fact that a taxpayer devotes much of his personal time and effort to carrying on an activity may indicate an intention to derive a profit, particularly if the activity does not have substantial personal or recreational aspects. (Regulation §1.183-2(b)(3)) However, time and effort may be devoted to an activity that has substantial personal and recreational aspects on account of a taxpayer's enjoyment of that activity rather than the taxpayer's intention to derive a profit. *(White,* (1954) 23 TC 90)

Mr. Stettner was unemployed when he started AJS in 2011 and devoted 40-60 hours per week to it. He became gainfully employed in 2012 and thereafter devoted 15-20 hours per week to AJS. The Court said that, although Mr. Stettner derived much pleasure from racing, it found that he also spent significant personal time and effort preparing his cars for racing events. Accordingly, this factor favored the Stettners.

d. Taxpayer's history of income or loss from the activity. A taxpayer's history of income or loss with respect to an activity may indicate the presence or absence of a profit motive. A series of losses during the initial stage of an activity does not necessarily indicate a lack of profit motive. (Regulation §1.183-2(b)(6)) The goal, however, must be to realize a profit on the entire

> operation, which presupposes not only future net earnings but also sufficient net earnings to recoup losses incurred in the intervening years. (*Bessenyey,* (1965) 45 TC 261)

AJS reported net losses of $62,769 and $16,016 for 2011 and 2012, respectively, and the Court determined that AJS had net losses of at least $2,260 and $754 for 2013 and 2014, respectively. The Court also questioned the accuracy of AJS's reported net profits for 2015 because it did not find credible Mr. Stettner's testimony that he purchased tools during 2014 and 2015 in connection with his employment at Kremer but did not use those tools in connection with AJS's activities (particularly because he reported more unreimbursed employee expenses than wages from Kremer for 2014). Accordingly, that testimony reflected adversely upon Mr. Stettner's general credibility. Therefore, AJS may have paid additional expenses in 2015 that were not reported as Schedule C expenses but rather were reported as unreimbursed employee expenses on Schedule A. The Court said that it was highly skeptical that the Stettners would realize a profit on the entire operation because AJS would not generate sufficient net earnings to recoup prior losses. Accordingly, this factor favored IRS.

Tax Court order, Mark H. Swartz, Docket No. 3583-10.

The Tax Court has issued an order in which it determined that a taxpayer's criminal conviction for stealing $12.5 million from his employer precludes him from arguing that he did not receive taxable income in that amount. The Court, however, did not decide the tax consequences of his later-year repayment.

Under the doctrine of collateral estoppel (also known as issue preclusion), any issue actually litigated in a prior action between two or more parties is conclusive of the same issue raised in a later action between the same parties or those in privity of interest with them.

For collateral estoppel to be invoked: (1) the issue must be identical in the pending case to that decided in the prior proceeding; (2) the issue must necessarily have been decided in the prior proceeding; (3) the party to be estopped must have been a party or have been adequately represented by a party in the first proceeding; and (4) the precluded issue must actually have been litigated in the first proceeding. (*Blohm v. C.I.R.,* (CA 11, 1993) 72 AFTR 2d 93-5347)

In general, taxable income includes income received via embezzlement, larceny, false pretenses, extortion, or any other types of theft. (§61(a); *James v. U.S.,* (Sup Ct 1961) 7 AFTR 2d 1361) However, in certain circumstances an embezzler's income may be reduced if there is restitution-i.e., an actual repayment-in the same year as the embezzlement. (Buff, (1972) 58 TC 224)

Mark Swartz was a CFO for Tyco International. Mr. Swartz participated in Tyco's Key Employee Loan Program (KELP) for its executive officers, including in 1999 (the year at issue). In August 1999, a handwritten journal entry in Tyco's accounting records reduced Mr. Swartz's outstanding loan balance by $12.5 million. He did not make any payments on this loan to Tyco during the year at issue or include the $12.5 million on his Form 1040 (for example, as cancellation-of-debt income), and Tyco did not include the amount on Mr. Swartz's W-2.

In 2001, a conversation between a law firm employed by Tyco and Mr. Swartz about the mysterious 1999 journal entry led to the journal entry being reversed, and, in 2002, Swartz repaid the $12.5 million with interest.

Thereafter, Mr. Swartz was convicted of larceny and conspiracy with respect to the $12.5 million.

IRS argued that Mr. Swartz's conviction for stealing $12.5 million precludes him from arguing that he did not have $12.5 million in unreported taxable income in 1999. Mr. Swartz, however, claimed that the issues in his tax case were different than those in his criminal trial because, in 2002, Tyco adjusted its records to reflect a $12.5 million repayment obligation and then Mr. Swartz paid it. According to Mr. Swartz, this shows the alteration of Tyco's records back in 1999 was null and void and that voided transactions, like that which result from erasing and then restoring the record of a debt in corporate books, do not create taxable income.

The Tax Court concluded that collateral estoppel applied such that Mr. Swartz could not argue that he did not receive $12.5 million in taxable income in 1999. He had claimed that the elements were not all met because he did not present his "null and void" theory in the criminal case, so the issue was not identified or actually litigated. The Court, however, found that he was not entitled to a "do-over" in the second case and could not assert new arguments in hopes of obtaining a different determination.

The Court also found that, regardless of his entitlement to raise the "null and void" argument, that argument would not change the result. It cited the Supreme Court's James decision, in which the Court wrote that "it is inconsequential that an embezzler may lack title to the sums he appropriates while an extortionist may gain a voidable title. Questions of federal income taxation are not determined by such "attenuated subtleties.""

In addition, the Court found that the limited exception for funds that are repaid in the same year as they were embezzled did not apply because Mr. Swartz did not repay until 2002, after getting caught. The Court did note, however, that "the tax consequences of Mr. Swartz's repayment of the embezzled funds in 2002 are not before us here."

Taylor, TC Memo 2017-132.

A fireman who retired on disability could not exclude his retirement allowance. The allowance payments were computed with reference to his age, length of service, and average final compensation and thus were not excludable under §104(a)(1).

Under §104(a)(1), gross income does not include amounts received under workmen's compensation acts as compensation for personal injuries or sickness. This exclusion also applies to statutes in the nature of workmen's compensation acts which provide compensation to employees for personal injuries or sickness incurred in the course of employment. But the exclusion does not apply to a retirement pension or annuity to the extent that it is determined by reference to the employee's age or length of service, or the employee's prior contributions, even though the employee's retirement is occasioned by an occupational injury or sickness. (Regulation §1.104-1(b))

Jack Taylor worked as a North Carolina fireman for over 24 years before retiring on disability in 1991. In that year, the Local Governmental Employees' Retirement System of North Carolina (LGERS), a defined benefit plan funded by employer and employee contributions, began paying Taylor a disability retirement allowance. The allowance was computed with reference to his age, length of service, and average final compensation before his disability retirement. The allowance was subject to periodic medical exams, and reduction if he earned more than a specific amount.

In relevant part, LGERS provides that an employee retiring for disability after July 1, 1982, gets a service retirement allowance calculated on the member's average final compensation prior to his disability retirement and the creditable service he would have had if he continued in service until the earliest date on which he would have qualified for an unreduced service retirement allowance. The amount is based on a percentage of average final compensation multiplied by the years of creditable service. A former employee receiving a disability retirement allowance, upon reaching the earliest date on which he would have qualified for an unreduced service retirement allowance, ceases to receive a disability retirement allowance and instead is considered a beneficiary in receipt of a service retirement allowance.

When Taylor turned 60 in August 2004, LGERS sent him a letter notifying him that he was being transferred from disability retirement to regular service retirement effective September 1, 2004.

For 2012, Taylor was paid $35,153 in retirement benefits by LGERS which sent him a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., indicating that he had received $34,829 in taxable retirement benefits during the 2012 tax year.

On his 2012 return, Taylor reported $2,324 of taxable retirement income. IRS audited his return and, among other adjustments, increased the $2,324 by $32,505 to arrive at the $34,829 of taxable income reported on the Form 1099-R generated by LGERS.

Taylor's position was that the LGERS payments were neither a retirement pension nor an annuity under Regulation §1.104-1(b), since they were not necessarily payable for life. If he were determined to be fit for work, his disability retirement payments would cease. Because he was subject to medical reexaminations and his disability retirement allowance could be reduced if he were determined to be able to earn over a certain amount, Taylor said his payments were not for life and so were not a retirement pension or annuity.

IRS maintained that since Taylor's disability retirement allowance was calculated with reference to his age and length of service, it was includible in his gross income. IRS further asserted that, regardless of the initial classification of Taylor's retirement income, he was no longer receiving a disability retirement allowance. Under the LGERS rules, once a beneficiary in receipt of a disability retirement allowance becomes eligible for an unreduced service retirement allowance, he is deemed to be in receipt of the latter. This occurred when Taylor turned 60 years old in 2004, eight years before the tax year in issue.

The Tax Court pointed out that there was nothing to support Taylor's assertion that a pension had to be for life. Nor was there corroboration for his suggestion that a pension cannot be conditional upon certain factors, such as continued medical verification of disability. Similarly, it was well established that an annuity is a yearly payment of a certain sum of money granted to another in fee for life or for a period of years. As with pensions, there was nothing to support Taylor's contention that annuities must be for life and cannot be terminable.

LGERS was a pension plan, and the disability payments it made to Taylor were computed with reference to his age, length of service, and average final compensation before his disability retirement. Thus, the §104(a)(1) exclusion for workmen's compensation did not apply.

Because the Tax Court found that Taylor's disability retirement allowance under LGERS was a retirement pension determined by reference to his age and length of service, it did not need to address the extent to which Taylor, in 2004 upon his 60th birthday, was transferred from a disability retirement allowance to a service retirement allowance. The Tax Court established that Taylor's disability retirement allowance was not received under a workmen's compensation act or a statute in the nature of such, and so was not excludable from gross income under §104. If Taylor remained on a disability retirement allowance after 2004, then the treatment of his payments-includible as they were in gross income-would have been unchanged. If Taylor in 2004 ceased to receive a disability retirement allowance and was considered thereafter a beneficiary in receipt of a service retirement allowance under state law, then he would receive a pension calculated by reference to his age and length of service. Such a pension too would not fall within the §104(a)(1) exclusion.

Tinsley, TC Summary Opinion 2017-9.

A shareholder's guarantee of a loan to his S corporation did not give him basis in the entity and as a result he could not deduct his distributive share of the entity's losses. The shareholder could not establish that the lender looked primarily to him, rather than to the S corporation, for repayment, and could not establish that he made an economic outlay with respect to the loan.

Deductions and losses of an S corporation are passed through to shareholders and (except as otherwise limited by the Code) claimed on their own returns. However, a shareholder may deduct his pro rata share of these passed-through items only to the extent of the sum of his adjusted basis in the S corporation stock-determined by taking into account the increases in basis for his share of the S corporation income during the year and the decreases in basis for nondividend distributions for the year (§1366(d)(1)(A) -plus his adjusted basis in any indebtedness of the S corporation to him. (§1366(d)(1)(B), Regulation §1.1366-2)

Under regulations that generally apply to transactions on or after July 23, 2014, an S corporation shareholder who merely acts as a guarantor or in a similar capacity (e.g., surety or accommodation party) has not created basis of indebtedness unless the shareholder actually makes a payment, and then only to the extent of such payment. (Regulation §1.1366-2(a)(2)(ii))

For transactions before July 23, 2014, the courts generally held that merely guaranteeing an S corporation's debt was not enough to generate a basis under §1366(d)(1)(B). To increase his basis in an S corporation, a shareholder had to make an "actual economic outlay."

In *Selfe,* (CA 11 1985) 57 AFTR 2d 86-464, the Eleventh Circuit held that a guaranty of a loan to an S corporation "may be treated for tax purposes as an equity investment in the corporation where the lender looks to the shareholder as the primary obligor."

William Tinsley was the sole shareholder of Command Computers, a Florida S corporation engaged in the business of computer design and service. On April 5, 2006, Command Computers borrowed $150,000 from First City Bank of Florida (Bank). Tinsley guaranteed the loan. Command Computers was liquidated in August of 2010. At the time of liquidation, Command Computers owed Bank $110,480.

On its timely filed 2010 Form 1120S, U.S. Income Tax Return for an S Corporation, Command Computers reported an ordinary business loss of $136,243. Tinsley had no stock or debt basis in Command Computers when it was liquidated.

After Command Computers was liquidated, the operations of the business continued under its former name (not revealed in the case). Command Computers' 2006 loan with Bank was renewed on March 16, 2011, and Command Computers remained the named borrower of the renewed loan even though it no longer legally existed. Tinsley signed the renewal note as president of Command Computers and was the guarantor of the loan. The amount of the renewed loan was $104,772. Attached to the renewal note was the original promissory note, dated April 5, 2006, on which a handwritten notation stated: "Sec by--Inventory & Equipment". The renewal note provided that a final balloon payment was due on March 16, 2016.

Tinsley made all loan payments following the liquidation of Command Computers, but the facts did not show whether he made the payments from his personal funds or merely signed checks drawn on the account of Command Computers.

On his 2010 return, Tinsley deducted as a business loss $110,480, which represented a portion of his distributive share of Command Computers' current and suspended (2008) flowthrough losses. IRS disallowed the loss deduction. Its explanation of the disallowance said, "Since your distributive share of [Command Computers'] loss is limited to the extent of your adjusted basis, we have disallowed the amount in excess of your basis, your loss flow-through from your S Corporation is limited to your basis. Since you did not establish that the amount shown was (a) a loss, and (b) sustained by you, it is not deductible."

Before the Tax Court, Tinsley conceded that he had no stock or debt basis in Command Computers at the time of its liquidation in 2010. However, he contended that upon the liquidation, he assumed the balance due on the note as guarantor, and because he was the sole remaining obligor, this assumption was a contribution to capital, allowing him to deduct the amount of Command Computers' losses. He also asserted that following Command Computers' liquidation, Bank expected him, as guarantor, to repay the loan and that Bank's expectation was sufficient to generate a basis for him in Command Computers.

The Tax Court held Tinsley did not have enough basis in Command Computers to claim a passthrough business loss.

Under §7463(b), a Tax Court Summary Opinion cannot be reviewed in any other court. However, the Court said that because its decision would be appealable to the Eleventh Circuit were it not a small tax case, it was bound by that Circuit's holdings. Thus, the Court said its decision depended on whether Tinsley could establish that by the end of 2010: (1) Bank looked to Tinsley for repayment and (2) Tinsley made economic outlays in making those payments.

The Tax Court held that Tinsley presented no evidence to support a finding that Bank looked primarily to him, as opposed to Command Computers, for repayment of the loan. True, Tinsley continued to make payments on the loan, but there was no indication that the loan payments were made from his personal funds rather than Command Computers' funds with Mr. Tinsley signing payment checks as president.

Moreover, the Tax Court pointed out that under the terms of the renewal note, the renewed loan was to Command Computers and that Tinsley's obligation was that of a guarantor, not the maker of the loan. Additionally, the promissory note for the 2006 loan, which was appended to the 2011 renewal note, included a notation that the loan was secured by Command Computers' inventory and equipment. Thus, the Tax Court concluded that (1) even after its liquidation Command Computers, continued to operate, and (2) Bank continued to look to Command Computers as the primary obligor on the loan and expected it to make the loan repayments.

The Court held that there was insufficient evidence for it to conclude that in both 2006 and 2011 the loan was made to Tinsley personally, as opposed to Command Computers, and that he, as the borrower, advanced the loan proceeds to Command Computers. Because Tinsley failed to establish that Bank looked primarily to him to satisfy the debt obligation or that he made an economic outlay with respect to the loan, he failed to prove he had a basis in Command Computers as of December 31, 2010 that was sufficient for him to deduct the reported business losses.

Yosef A. Tsehay, AOD 2017-05,07/10/2017.

An Action on Decision (AOD) announcing its nonacquiescence with a Tax Court decision that a taxpayer with a filing status of married filing separately may claim the earned income tax credit under §32.

Under §32(d), an individual who's married and who otherwise qualifies as an eligible individual must file a joint return for the tax year to claim the EITC. (§32(d); Regulation §1.32-2(b)(2)) Filing as married filing separately does not qualify. (*Harkless*, TC Memo 1999-58)

The Tax Court case, *Tsehay,* TC Memo 2016-200, involved a taxpayer who had separated from his wife when he was ready to file his 2013 tax return, and asked his preparer to file for him as married filing separately. The preparer erroneously filed his return as head of household. The Tax Court held that since the taxpayer was married for 2013, he could not qualify for head of household filing status for that year, or for single status as determined by IRS in its notice of deficiency. The Tax Court held that the taxpayer's correct filing status for 2013 was married filing separately.

Among other holdings, the Tax Court also decided that, because the taxpayer had qualifying children for tax year 2013, he was entitled to the EITC.

The AOD notes that there is no mention in the Tax Court's opinion of §32(d), which clearly provides that a married taxpayer who does not file a joint return is not entitled to an EITC. IRS stated that "it appears that the Tax Court overlooked the prohibition disallowing the EITC to married taxpayers filing separately."

Accordingly, IRS will not follow the court's opinion in Tsehay in allowing an EITC to a married taxpayer filing separately.

Observation: §32(d) specifically provides that if an individual is married, the EITC applies only if a joint return is filed for the tax year. What's more, the Tax Court itself has held that filing as married filing separately does not qualify. (*Harkless,* TC Memo 1999-58)

The nonacquiescence is restricted to the holding in Tsehay that a taxpayer with a filing status of married filing separately may claim the earned income tax credit under §32.

Tucker, TC Memo 2017-183

The Tax Court, while denying a loss for offsetting foreign currency options because the underlying option transactions lacked economic substance, has concluded that the taxpayer, the CEO of a financial services firm, was not liable for an accuracy-related penalty because there was reasonable cause and the taxpayer acted in good faith.

Taxpayers are subject to a 20% accuracy-related penalty for an underpayment of tax required to be shown on a return that is attributable to a substantial valuation misstatement. (§6662(a) , §6662(b)(3)) The penalty is 40% of the portion of an underpayment of tax attributable to one or more substantial valuation misstatements that meet the requirements for a gross valuation misstatement. (§6662(h)) A gross valuation misstatement exists if the value or adjusted basis of any property claimed on a tax return is 200% (400% under a prior version of this provision that was applicable to this taxpayer's case) or more of the amount determined to be the correct amount of such value or adjusted basis. (§6662(h)(2)(A))

Under §6664(c)(1) , an accuracy-related penalty under §6662 will generally not apply to any portion of an underpayment if it is shown that there was reasonable cause for that portion and that the taxpayer acted in good faith. Reasonable cause requires that the taxpayer exercise ordinary business care and prudence as to the disputed item. (*Neonatology Associates,* (2000) 115 TC 43 , aff'd (CA 3 2002) 90 AFTR 2d 2002-5442). Good faith means, among other things, an honest belief and an intent to perform all lawful obligations. (*Hirschfeld,* (CA 4 1992) 70 AFTR 2d 92-5697) A taxpayer's education and business experience are relevant to the determination of whether the taxpayer acted with reasonable reliance on an adviser and in good faith. (Regulation §1.6664-4(b)(1))

The Supreme Court recognized that a taxpayer exercises "[o]rdinary business care and prudence" when he reasonably relies on a professional's advice on matters beyond the taxpayer's understanding. Further, a taxpayer need not challenge an independent and qualified adviser, seek a second opinion, or monitor advice on the provisions of the Code. (*U.S. v. Boyle,* (S Ct 1985) 55 AFTR 2d 85-1535)

A taxpayer claiming reliance on a tax professional must prove that: (1) the adviser was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer provided necessary and accurate information to the adviser; and (3) the taxpayer actually relied in good faith on the adviser's judgment. (*Neonatology*)

Mr. Keith Tucker, who had a bachelor of business administration degree with a major in accounting and a minor in finance (1967) and a law degree (1970), was licensed as a certified public accountant (CPA) but never practiced law. Early in his career, he worked at the KPMG CPA firm and became a partner in 1975. Mr. Tucker started his KPMG career preparing individual tax returns and then life insurance company returns and eventually became an expert in the insurance taxation field. In 1984, Mr. Tucker left that field, joined an investment banking firm, and became involved in mergers, acquisitions, public and private placements, and corporate finance.

From 1992 to 2005, Mr. Tucker was the chief executive officer (CEO) of Waddell & Reed Financial, Inc. (Waddell & Reed), a national mutual fund and financial services company targeting middle class individual investors and small businesses.

Waddell & Reed established a company-sponsored personal financial planning program (WR executive program) for its senior executives, including Mr. Tucker, that provided financial, estate, and income tax planning and tax return preparation services. Part of Waddell & Reed's reasoning for this was concern with its own reputation and client relationships as affected by the ethical conduct of its executives, including tax compliance issues.

KPMG prepared Mr. Tucker's returns for 1984 through 2000 and advised him on various investment, income, and estate planning issues. Upon Mr. Tucker's recommendation, Waddell & Reed engaged KPMG to manage the WR executive program. Mr. Tucker recommended Eugene Schorr, a friend, former KPMG colleague, and a personal financial specialist, to run the WR executive program.
In May 2000, before exercising his Waddell & Reed stock options, Mr. Tucker met with KPMG advisers to discuss his financial and tax planning for 2000, including his exercise of the Waddell & Reed stock options. KPMG had trained and directed its partners to refer clients with income over a certain threshold to KPMG's Innovative Strategies Group. Mr. Schorr identified Mr. Tucker as a potential client for the Innovative Strategies Group in the spring of 2000 on the basis of Mr. Tucker's 2000 income from his exercise of the Waddell & Reed stock options. Mr. Schorr asked Timothy Speiss, the northeast partner in charge of KPMG's Innovative Strategies Group, to meet with Mr. Tucker to discuss tax strategies to mitigate his 2000 income tax. Mr. Tucker relied on Mr. Schorr's recommendation of Mr. Speiss because Mr. Tucker trusted Mr. Schorr. Mr. Tucker viewed his conversations with KPMG as part of the WR executive program.

KPMG proposed a tax strategy referred to as "short options" and explained that the strategy would mitigate petitioners' 2000 income tax from the Waddell & Reed stock options (short options strategy). However, IRS subsequently issued Notice 2000-44, 2000-2 CB 255 , which described the son of BOSS tax shelter and identified as a listed transaction the simultaneous purchase and sale of offsetting options and the subsequent transfer of the options to a partnership. As a result of the issuance of Notice 2000-44 , KPMG informed Mr. Tucker that KPMG could no longer recommend the short options strategy. In any event, Mr. Tucker no longer wanted to engage in the short options strategy because of the potential negative impact on his personal and professional reputation, his career, and Waddell & Reed's reputation had he engaged in an abusive tax scheme.

After the "short options" transaction fell through, Mr. Speiss discussed with and sought approval from several members in KPMG's tax leadership positions to develop and propose a customized tax solution that involved foreign currency options to mitigate Mr. Tucker's 2000 income tax by the end of the year. Mr. Speiss recommended a transaction involving foreign currency options (FX transaction).

On or around December 26, 2000, Mr. Tucker engaged the law firm Brown & Wood to provide a tax opinion with respect to the FX transaction upon KPMG's recommendation. Mr. Tucker understood that he needed a legal opinion as an "insurance policy" to ensure that the tax treatment of the FX transaction was proper and to protect against risk of IRS penalties. He did not understand that Brown & Wood was involved with the development of the FX transaction.

Mr. Tucker decided to implement the FX transaction and signed an engagement letter, dated December 27, 2000, for KPMG to provide tax consulting services relating to the FX transaction. Mr. Tucker worked with Mr. Speiss to implement the transaction during the last two weeks of December 2000.

On his return, based on the FX transaction, Mr. Tucker claimed a loss deduction arises from a series of offsetting foreign currency digital options that he entered into through passthrough entities. One set of offsetting foreign currency options generated the loss, and a second set of offsetting foreign currency options generated a tax basis in an S corporation through which he claimed the loss deduction. Through a technical application of statutory and regulatory provisions, Mr. Tucker separated the loss and gain from the offsetting options and claimed only the loss portion as U.S. source.

On audit, IRS issued Mr. Tucker a notice of deficiency disallowing his claimed loss deduction of $39,188,666 for the 2000 tax year, resulting in a $15,518,704 deficiency and a $6,206,488 §6662 penalty.

Before trial, Mr. Tucker conceded the issue of the tax basis in the S corporation but continue to assert the deductibility of a $2,024,700 loss for 2000 based upon his purported cash basis in the S corporation. He sought to carry forward the remainder of the loss deduction to the extent of stock basis in future years.

At trial, the Tax Court held that the taxpayer was not entitled to deduct a loss for 2000 on the offsetting foreign currency options because the underlying option transactions lacked economic substance. The Court also considered the issue of whether the taxpayer was liable for an accuracy-related penalty under §6662 .

The Tax Court determined that Mr. Tucker was not liable for the §6662 penalty on the basis of his reliance on Mr. Schorr of KPMG. When KPMG recommended the FX transaction, Mr. Tucker believed it was a legitimate tax planning solution, and, because of his past experiences, he did not expect that KPMG would recommend an abusive tax shelter. While Mr. Tucker was motivated to reduce his 2000 income tax liability, he consistently represented to KPMG that he did not want to put his own reputation or career on the line as a result of a tax scheme.

The Court reasoned that Mr. Tucker had a long-term relationship with both KPMG and Mr. Schorr, whom he viewed as a friend. Mr. Schorr introduced and recommended Mr. Speiss. KPMG had prepared the taxpayer's returns for 15 years without audit. Mr. Tucker had recommended Mr. Schorr to manage the WR executive program when it was created. Mr. Tucker did not solicit or initiate the contemplation of a tax strategy. Mr. Tucker believed that KPMG was offering its services as part of the WR executive program, which Waddell & Reed established to ensure that its executives were in compliance with tax law.

Further, Mr. Tucker had informed KPMG that he did not want to engage in a transaction that would subject him to IRS scrutiny because of concern for his professional reputation and career and the potential impact on Waddell & Reed's reputation as its CEO. After the issuance of Notice 2000-44 , Mr. Tucker was adamantly against participating in such a transaction, and KPMG repeatedly assured him that Notice 2000-44 did not apply to the FX transaction. Mr. Tucker believed that KPMG would protect his interests as KPMG had done when it terminated the short options strategy in response to Notice 2000-44 and that KPMG would not recommend an abusive tax shelter. KPMG's withdrawal of the short options strategy after the issuance of Notice 2000-44 confirmed this.

The Court noted that Mr. Schorr did not have a financial interest in the FX transaction as a tax shelter promoter and would not financially benefit from the fees involved. Mr. Tucker knew that Mr. Speiss at KPMG created the FX transaction as a customized tax solution to mitigate his 2000 income tax. Yet he did not understand that Mr. Speiss' involvement created an inherent conflict of interest with his longstanding relationship with Mr. Schorr and KPMG as his return preparer.

The Tax Court found that Mr. Tucker made a sufficient good-faith effort to assess his 2000 income tax and reasonably relied on Mr. Schorr's professional advice. To find otherwise would require taxpayers to challenge their attorneys, seek second opinions, or try to independently monitor their advisers on the complex provisions of the Code.

The Court placed little weight on Mr. Tucker's failure to review certain documents relating to the FX transaction. As a senior executive, Mr. Tucker depended heavily on his personal assistant. The Court did not view Mr. Tucker's following his normal practices when dealing with his taxes as a failure of good faith or reasonable diligence. Similarly, the Court did not find the fact that Mr. Tucker did not read Notice 2000-44 himself to preclude a finding of reasonable reliance on his adviser. Mr. Tucker, who had experience with insurance tax matters in the early part of his career, left the tax field in 1984 and focused entirely on the financial services industry. Mr. Tucker relied on KPMG because he believed that he would not understand the technical tax implications of the FX transaction. Despite his background, C.P.A. license, and law degree, Mr. Tucker had little understanding of the complicated tax issues involved in the FX transaction.

At the time of the FX transaction, KPMG was one of the largest U.S. accounting firms. Mr. Tucker viewed Mr. Schorr as a preeminent person for coordinating tax return compliance and tax and financial planning. Mr. Tucker believed KPMG misled him.

Mr. Tucker was forced to resign as CEO of Waddell & Reed and is no longer employable in the financial services industry. In the end, Mr. Tucker lost his position because of his participation in the FX transaction and received a large settlement from KPMG for his lost future compensation. The Tax Court noted that it found that Mr. Tucker's representations in his arbitration proceeding against KPMG supported his assertion that he relied on the advice he received from KPMG in good faith.

Turan, TC Memo 2017-141.

Taxpayer's found to have not elected to switch from the default first-in, first-out (FIFO) rule for determining the basis of stock that he sold through the broker. Taxpayer was liable for the accuracy-related penalty for not reporting sales at all on his income tax return, the Court found him liable for the accuracy-related penalty.

As relevant here, basis is the cost incurred by taxpayers when acquiring property. (§1012) When taxpayers sell shares of stock, they must compute their tax gain or loss by finding the difference between their cost basis and amount realized. (§1001(a))

As a general rule, when taxpayers hold multiple lots or shares of identical stock, they must compute their gains or losses against the basis of those shares actually sold, not the shares the taxpayer intended to sell. (*Davidson,* (S Ct 1938) 21 AFTR 960) As this rule may prove onerous for high-volume or high-frequency traders, regulations have been promulgated to provide relief. Under the regulations, by default, taxpayers owning blocks of identical stock acquired on different dates or for different prices determine their stock's basis by using the FIFO method. (Regulation §1.1012-1(c)(1))

If taxpayers can adequately identify the specific shares of stock they wish to sell or transfer, the regulation permits taxpayers to opt out of the default regime and use the basis correlated to those specifically identified shares. (Regulation §1.1012-1(c)(1)) When securities are left in the custody of a broker, taxpayers wishing to avoid use of the FIFO method must direct their broker accordingly, and adequately identify the particular shares they wish to sell. (Regulation §1.1012-1(c)(2) and Regulation §1.1012-1(c)(3)(i))

In such a situation, a taxpayer will be considered to have adequately identified shares if (a) the taxpayer at the time of the sale designates a particular lot or lots to be sold and (b) the broker confirms the taxpayer's instructions in a writing within a reasonable time thereafter. (Regulation §1.1012-1(c)(3)) Adequate identification, by whatever means made, must be timely in relation to the sale: "no later than the earlier of the settlement date or the time for settlement required by Rule 15c6-1 under the Securities Exchange Act of 1934." (Regulation §1.1012-1(c)(8))

A taxpayer is liable for the accuracy-related penalty as to any portion of an underpayment attributable to, among other things, a substantial understatement of income tax. (§6662(a), §6662(b)(2)) A substantial understatement exists when the amount of the understatement exceeds the greater of 10% of the tax required to be shown on the return for the tax year or $5,000. (§6662(d)(1)) IRS bears the burden of production with respect to this penalty. (§7491(c)) Once IRS meets his burden of production, the taxpayer must come forward with persuasive evidence that the penalty is inappropriate because, for example, he or she acted with reasonable cause and in good faith. (§6664(c)(1))

The taxpayer, Mr. Turan, was a real estate agent and a paid income tax return preparer, and he routinely traded on the stock market.

Turan traded on the stock market through a personal brokerage account with Scottrade, Inc. Scottrade held custody of Turan's stocks in street name.

Scottrade uses the FIFO method to determine the tax basis and calculate gains or losses unless a client directs otherwise. Scottrade issues a monthly transaction statement to its clients. This statement includes a conspicuous notification alerting Scottrade's clients to the firm's default use of the FIFO method. The notification informs those of Scottrade's clients who wish to use a different method for determining basis that they may do so by directing Scottrade to do so.

Turan owned 100,000 shares of FNMA stock in his Scottrade account. Turan's FNMA stocks were identical but for the time and cost at which he acquired them. In 2013, he had made 16 separate sales of FNMA stock. Scottrade regularly issued to Turan monthly account statements, and it sent him Forms 1099-B, Proceeds From Broker and Barter Exchange Transactions, for these sales. Both the statements and the Forms 1099-B reflected a FIFO cost basis for the FNMA shares.

When Turan prepared his Federal income tax return for 2013, however, he failed to report any gains or losses from these sales and did not include a Schedule D, Capital Gains and Losses, with his return.

IRS sent Turan a notice of deficiency. Turan conceded all determinations in the notice of deficiency except the basis values IRS used to determine Turan's gains or losses on his sales of FNMA stock.

The Tax Court rejected Turan's argument that IRS and Scottrade both erred in failing to use the last-in-first-out (LIFO) method to determine the bases of his FNMA shares.

Turan testified that in mid-2013, he attempted to inform Scottrade of his desire to use LIFO instead of FIFO by way of their internet client portal but was unable to do so because of an error on Scottrade's website. He stated that he phoned the firm in an attempt to work around this error but received no assistance. Turan did not testify as to whether he ever again attempted to make this election for 2013 or otherwise contacted Scottrade during the seven months in between his initial attempt and his filing of his income tax return.

The Court said that Turan offered no documentation or other objective indicia to corroborate his claim of a computer error or any misfeasance on the part of Scottrade. The Court found Turan's testimony lacked credibility, especially in light of Scottrade's declaration indicating the company had no record of being contacted by or on behalf of Turan with respect to directing the firm to determine his FNMA bases in any specific manner.

The Court found that Turan never instructed his broker to administer his account using any method other than the regulatory default FIFO method, or otherwise adequately identified the specific stock to be sold at the time of sale.

The Tax Court also found Turan liable for an accuracy-related penalty.

Although Scottrade issued Turan Forms 1099-B for all of his stock sales, Turan did not report these amounts. Turan attributed his failure to his belief that Scottrade erred in determining his bases and calculating his gains and losses. Turan did not attempt to contact Scottrade to request corrections, nor did he seek legal or professional advice or assistance in addressing these perceived errors or in ascertaining how to proceed in reporting these sales on his tax return for 2013. Rather, he prepared his return and decided to omit a Schedule D.

And the Court said, when it considered Turan's sophistication and his training and employment as a paid preparer of income tax returns, it found his failure characteristic of an unreasonably insufficient effort to ascertain his proper tax liability.

University of Utah, (DC UT 9/21/2017) 119 AFTR 2d ¶ 2017-5257

A district court has ruled that medical residents working for the University of Utah were subject to FICA tax because the agreement between the State of Utah and the Social Security Administration (SSA) did not exclude the residents from the Social Security system.

42 USC 418 ("Section 218" of the Social Security Act) allows states to voluntarily opt-in to the Social Security system by entering into an agreement with the Commissioner of Social Security (Commissioner). Through a " §418 or §218 agreement," as it is commonly called, a state may define to a certain extent which state employees participate in Social Security. The Code incorporates the various state §418 agreements by excluding from FICA taxation "service performed in the employ of a State" unless that service is "included under an agreement entered into pursuant to section 218 of the Social Security Act." (§3121(b)(7)(E))

When opting in classes of employees through a §418 agreement, states may also employ exclusions in their agreement to ensure that specified subsets of employees are not opted-in through the §418 agreement. One of the optional exclusions that a state may include within its §418 agreement is for "service performed by a student" (42 USC 418(c)(5)), which is defined as applying to service performed in the employ of a school, college, or university if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university. (42 USC 418(c)(5), 42 USC 410(a)(10))

In 1978, the Commissioner issued a ruling addressing Arizona's contention that medical residents were not employees because, among other arguments, "they were students whose services were excluded from coverage under [Arizona's] section 218 agreement." In that ruling, the Commissioner found the medical residents were not excluded from coverage under the student exclusion in Arizona's §418 agreement, explaining that "the Social Security Administration has always held that resident physicians are not students." But, in *Minnesota v. Apfel, (CA 8 1998) 151 F3d 742*, the Eighth Circuit declined to defer to the SSA ruling. In response to Apfel, the SSA issued an "Acquiescence Ruling," stating that "under SSA rules, the services performed by medical residents do not qualify for the student exclusion," but that the SSA would apply Apfel's case-by-case approach in the Eighth Circuit.

In the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999 (Omnibus Act), Congress granted states a 3-month (January 1, 1999 through March 31, 1999) opportunity to withdraw their student employees from social security coverage under their §218 agreements.

Through 1999, the State of Utah's §218 agreement excluded "as provided by the Federal Statutes, services performed in the employ of a school, college, or university by a student who is enrolled and regularly attending classes at such school, college, or university on a full-time basis."

The State of Utah modified its §218 agreement in 1999 ("Modification 208") to exclude "service performed in the employ of a school, college, or university if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university for all coverage groups of the State and its political subdivisions currently (as of the date this modification is executed) included under this agreement and to which the agreement is hereafter made applicable." The only substantive change between Modification 208 and the prior student exclusion was that Modification 208 omitted the term "full-time basis" as a modifier to student. Modification 208 was signed during the statutory 3-month period referred to in the Omnibus Act.

The taxpayer was the University of Utah (the University), a state school.

Although the University consistently paid FICA taxes with respect to its medical residents, around the time that the State of Utah executed Modification 208, the University began requesting FICA tax refunds with respect to its medical residents for tax periods dating back to 1995. On December 23, 2015, the University sued IRS seeking refunds of FICA taxes that the University had paid with respect to medical residents.
Court holds that the residents were subject to FICA. The court, looking to contract law, concluded that the residents were not exempted.

The court said that obligations to and rights of the United States under its contracts are governed exclusively by federal law. The federal law of contracts is the general contract law that can be found in treatises and restatements. Restatement (Second) of Contracts §201(2) provides that if the parties attached different meanings to a term and one party has reason to know of the other party's meaning, then the meaning of the party who did not know of the other party's meaning prevails.

The court went on to say that, "a case almost identical to the case at hand," *University of Texas System et al. (CA 5 7/16/2014) 114 AFTR 2d 2014-5331* , held that residents were not excluded. There, the Fifth Circuit applied contract law principles to hold that medical residents at the University of Texas were not students within the meaning of Texas's §218 agreement. The University of Texas court relied on three reasons. First, when the State of Texas added a student exclusion to its §218 agreement in 1999, the SSA had "clearly disclosed its understanding that medical residents did not fall within the meaning of the term `student' as that term is used in the student exclusion that states could incorporate into their 218 agreements." In support of this, the court looked at: (1) the Commissioner of Social Security's 1978 ruling in which he explained that the SSA "has always held that resident physicians are not students"; and (2) the SSA's "Acquiescence Ruling."

Second, the University of Texas did not have any evidence that "Texas understood the student exclusion to carry a different meaning than that held by the SSA at the time the agreement was amended." More importantly, the court here said, even if Texas understood the student exclusion differently from the SSA's well-disclosed meaning, there was no reason for the SSA to have known this fact as Texas did not disclose any such contrary meaning to the SSA. That is, even if the University of Texas interpreted the term student to include medical residents, it never made the SSA aware of this interpretation; and thus the SSA's longstanding interpretation would prevail.

Third, the University of Texas court gave great weight to the fact that the University of Texas "repeatedly paid and withheld FICA taxes on its residents after the student exclusion was added to Texas's §218 agreement in 1999." That court cited Restatement (Second) Contracts §202(4) ("Where an agreement involved repeated occasions for performance by either party with knowledge of the nature of the performance and opportunity for objection to it by the other, any course of performance accepted or acquiesced in without objection is given great weight in the interpretation of the agreement").
The University made several arguments that its situation was different from that of the University of Texas. The court rejected all of those arguments.

For example, by the time Utah executed Modification 208, the SSA had made it clear that it did not interpret the term student to cover medical residents. The University claimed that, unlike University of Texas in which there was no evidence that Texas understood that its student exclusion covered medical students, "it was general knowledge in the administrative offices of the University in 1999 that Modification 208 would exclude medical residents from the regime of FICA taxation."

However, the court said, even assuming that the general knowledge at the University was probative of the State of Utah's understanding of its §218 agreement, the University provided no evidence that this understanding was ever communicated to the SSA. Even if the State of Utah understood the term "student" to include medical resident, it was aware (or certainly should have been) of the SSA's longstanding position that medical residents are not students. Assuming Utah understood the term student to include medical residents, this would simply be a case where Utah attached a meaning to a term - student - when it had reason to know that the SSA attached a different meaning to that term. In such a case, because Utah never communicated its understanding to the SSA, the SSA's understanding must prevail. See Restatement (Second) Contracts §201(2).

The Court was also unconvinced by the University's argument that, unlike in University of Texas, the parties' course of performance showed that the §218 agreement was intended to exclude medical residents. Unlike the University of Texas, which waited until 2008 to seek FICA tax refunds, the University filed claims for refunds in 1999 - close in time to Modification 208 - for tax periods starting in 1995. The court said that it failed to see how "the one-sided action" of requesting refunds evidences the SSA's understanding of the term student. It looked to Restatement (Second) Contracts §202(4). At best, it said, the refund requests showed that the University believed, perhaps half-heartedly, that the term student included medical resident. The SSA's contrary understanding of the term student was best reflected by the fact that it initially denied the University's refund requests.

Vest v. Commissioner, (CA 5 06/02/2017) 119 AFTR 2d ¶2017-813.

The Court of Appeals for the Fifth Circuit, affirming the Tax Court, has found that a taxpayer could not deduct the costs of investigating his father's death because the investigation was not motivated by profit. The Fifth Circuit also found that a sale of computer and intangible assets from one partnership controlled by the taxpayer to another did not qualify for the installment method because it was motivated by tax avoidance.

In general, a taxpayer is permitted to deduct expenses incurred in carrying on a business or in connection with the production or collection of income. (§162; §212) However, to be deductible, such expenses must be incurred with the "primary" objective of generating a profit. (*Westbrook v. Commissioner,* (CA 5 1995) 76 AFTR 2d 95-7397)

Under the so-called hobby loss rules, if an activity is not engaged in for profit, deductions generally are disallowed by §183 except to the extent of the gross income derived from the activity for the tax year. Regulation §1.183-2(b) enumerates nine factors to consider in determining whether a taxpayer has a profit objective, including, among others, the taxpayer's expertise, the time and effort expended by the taxpayer in carrying out the activity, the amount of any occasional profits, and the taxpayer's financial status. The list is not exhaustive, and no single factor is conclusive. Courts may accord certain factors greater weight than others.

§453 provides that income from an installment sale is taken into account under the installment method, that is, a portion of the total gross profit from an installment sale is included in income in each year in which the seller receives payment. An installment sale is a disposition of property where at least one payment is to be received after the close of the tax year in which the disposition occurs. (§453(b)(1))

However, the installment method of accounting is not available for "an installment sale of depreciable property between related persons" unless "it is established to the satisfaction of the Secretary [of the Treasury] that the disposition did not have as one of its principal purposes the avoidance of Federal income tax." (§453(g))

Following an audit, IRS determined deficiencies totaling approximately $4 million in the income taxes that Herb Vest owed for the years 2008 through 2010. Two alleged errors in Vest's income calculations are at issue-errors through which Vest allegedly avoided substantial alternative minimum taxable income from 2008 through 2010, resulting in total income tax deficiencies of approximately $4 million.

The first error relates to deductions that Vest claimed for business expenses stemming from a years-long investigation into the cause of his father's death. Vest undertook this investigation after receiving an anonymous letter in 2003 asserting that his father-whose death had previously been classified as a suicide-had been murdered. According to Vest, he viewed the letter as a business opportunity that, if publicized, could result in book and movie adaptations and also generate revenue for Vest's other businesses. Over the years, Vest, through partnerships that he controlled, expended significant sums for, among other things, hiring private investigators and a writer to draft a manuscript. According to IRS, these expenses were not deductible because they were spent in furtherance of an investigation that did not have a profit motive.

The second error concerns Vest's use of the installment method of accounting to report gross profits of approximately $3.2 million from the sale of computer equipment and intangible property by one partnership controlled by Vest to two other such partnerships. This sale occurred in January 2008 but payment was not due until January 2018-a fact the purchasing partnerships used to claim depreciation deductions on the assets before making a single payment on the property and the selling partnership used to defer the gain from the sale of the property for a decade. IRS determined that the installment method was not available to Vest because he failed to establish that a principal purpose of the transaction was not tax avoidance.

Vest petitioned the Tax Court for redetermination of the deficiencies, and on October 6, 2016, the Tax Court issued a decision siding with IRS.

The Court of Appeals for the Fifth Circuit, reviewing the lower court's decision for clear error, affirmed the Tax Court.

Vest challenged the Tax Court's determination that expenses incurred in the investigation of his father's death could not be deducted as business expenses because this investigation lacked the requisite profit motive. However, the Fifth Circuit found that the Tax Court's determination was amply supported by the record. The Tax Court applied the nine factors set out in Regulation §1.183-2(b) and found that none favored Vest, citing facts including the lack of annual profit in any year, the lack of a business plan, and Vest's own lack of expertise and personal interest in the matter. The Fifth Circuit found that Vest offered only "bare assertions" that his investigation was profit-motivated, which were insufficient to satisfy the objective test under §183 for demonstrating a profit motive.

The Fifth Circuit also agreed with the Tax Court's determination that the sales of computer equipment and intangible assets from one partnership controlled by Vest to two other partnerships that he controlled did not qualify for the installment method. Vest did not challenge the Tax Court's finding that the partnerships were "related persons" under §453, but he did dispute the Tax Court's determination that the computer equipment sale was structured as it was principally for tax avoidance purposes. Vest argued on appeal that the sale "was done for business purposes," but the Fifth Circuit found that, even if this were true, it would not mean that the sale did not also have a principal purpose of tax avoidance.

Vest also claimed that the intangible asset sale could not have been motivated by tax avoidance because he had a net operating loss for the years at issue, so his use of the installment method did not affect his tax burden. However, the Fifth Circuit agreed with the Tax Court's finding that use of the method allowed him to avoid substantial alternative minimum taxable income.

Windham, TC Memo 2017-68.

The Tax Court has rejected a stock broker's argument that she, in effect, made an election to treat all of her rental activities as one activity. But the Court nonetheless found that she was a real estate professional and that therefore her rental real estate activities were not passive activities.

In the case of an individual, §469 generally disallows any current deduction for a passive activity loss. (§469(a)(1), §469(b)) Under §469(c)(1), the passive activity loss disallowance rules apply to any trade or business in which the taxpayer does not materially participate. In general, any rental activity is per se a passive activity regardless of the taxpayer's participation in the activity. (§469(c)(2))

However, under §469(c)(7)(B), the per se rule for rental activities does not apply to a qualifying real estate professional. A taxpayer qualifies as such for a particular tax year if: (1) more than half of the personal services that the taxpayer performs during that year are performed in real property trades or businesses in which he or she materially participates; and (2) the taxpayer performs more than 750 hours of services during that tax year in real property trades or businesses in which he or she materially participates.

For purposes of determining whether a taxpayer materially participated in his rental real estate activities, each interest in rental real estate will be treated as a separate activity unless the taxpayer elected to treat all of his or her rental real estate activities as one activity. (§469(c)(7)(A); Regulation §1.469-9(e)(1)) To elect to group several rental real estate activities as one activity, a taxpayer's election must contain a declaration that the taxpayer is a qualifying taxpayer and is making the election pursuant to §469(c)(7)(A), and it must be filed with the taxpayer's original income tax return for the tax year. (Regulation §1.469-9(g)(3))

However, Revenue Procedure 2010-13, 2010-4 IRB 329, §4.06, provides: "A taxpayer is not required to file a written statement reporting the grouping of the trade or business activities and rental activities that have been made prior to the effective date of this revenue procedure...until the taxpayer makes a change to the grouping as described in sections 4.03 and 4.04 of this revenue procedure." The Revenue Procedure is effective for tax years beginning on or after January 25, 2010. (Revenue Procedure 2010-13, §5)

A taxpayer is treated as materially participating in an activity if he meets at least one of the seven tests in Regulation §1.469-5T(a). Three of those tests are

a. The individual's participation in the activity for the tax year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year (Regulation §1.469-5T(a)(2));

b. The individual participates in the activity for more than 100 hours during the tax year, and such individual's participation in the activity for the tax year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year (Regulation §1.469-5T(a)(3)); or

c. Based on all the facts and circumstance, the individual participates in the activity on a regular, continuous, and substantial basis during such year. (Regulation §1.469-5T(a)(7)) If the individual participates in an activity for 100 hours or less during the tax year, he is not treated as materially participating in the activity under this rule. (Regulation §1.469-5T(b)(2)(iii))

The taxpayer, Ms. Windham, was a stock broker for Wells Fargo during all of 2010. Windham generally worked at her brokerage office from 12:30 p.m. until the U.S. markets closed each weekday at 3 p.m. Windham was compensated on the basis of her production, and her accounts had assets totaling approximately $70 million.

Windham frequently met with her brokerage clients during business lunches and dinners. Most of the relevant receipts included the name or names of the individual or individuals who were entertained. The receipts did not, however, include the business purpose for any of the meals and entertainment.

Windham testified that the meals and entertainment expenses also included meals associated with her rental real estate activities and the various charities for which she volunteered.

In addition to her employment as a stock broker, Windham owned 12 rental properties and a 50% interest in a vacant lot; all of the properties were in Florida. Windham set aside the morning hours before going to her brokerage office to handle issues concerning her rental real estate.

Windham managed all aspects of her rental properties, including vetting potential tenants, collecting rent, and evicting tenants when necessary. She also negotiated with, hired, and oversaw contractors and repairmen working on the rental properties. Additionally, Windham acquired and maintained insurance on each rental property, maintained services and upkeep on vacant rental properties, maintained records for each rental property, and completed the necessary documents for her certified public accountant to prepare her Federal income tax returns.

She kept a log of the time she spent on each of the properties. The log showed a total of 901.25 hours for 2010.

She incurred some financial trouble with the properties that began with hurricanes in 2004 and 2005 and continued with the 2007-2008 downturn in the real estate market. In 2010, Windham withdrew $182,025 from her retirement accounts to meet her rental real estate business expense requirements. Windham properly reported $148,893 of her withdrawal as taxable income for 2010.

She reported a loss of $308,000 from her real estate activities on her 2010 return, which she used to offset her Wells Fargo income. She did not attach an election to treat all of her rental properties as one activity to her 2010 Form 1040. IRS issued to Windham a notice of deficiency, determining that her loss from her rental real estate activities was passive and could not be used to offset her Wells Fargo income.

The Court determined that Windham was a real estate professional and that therefore her rental real estate activities were not passive activities.

The Court considered whether Windham materially participated in her rental real estate activities. It first looked into whether, in making that determination, it should consider each interest in rental real estate as a separate activity or whether to treat all her rental real estate activities as one activity.

Windham argued that, under Revenue Procedure 2010-13, she was not required to make an election in order to treat all of her rental real estate activities as one activity. But the Court noted that Windham's tax year in issue was 2010, which began on January 1, 2010, i.e., before January 25, 2010. Therefore, Revenue Procedure 2010-13 did not apply, and Windham was required to file an election. Windham admitted that she made no such election; therefore, her rental real estate activities had to be treated as separate in determining whether she materially participated in them for 2010.

Then the Court looked to whether Windham materially participated in each of the separate properties. Her log indicated that she spent more than 100 hours each with respect to three of the properties. The Court found credible the number of hours Windham listed in her log. The Court also noted that Windham took significant distributions from her retirement accounts - approximately 77% of which was taxable and on which she properly paid income tax in 2010 - to keep her rental real estate activities afloat. Those funds were used to maintain all of her rental properties. It concluded that Windham spent a considerable amount of time and money to keep her rental real estate activities viable and that therefore Windham satisfied both Regulation §1.469-5T(a)(3) and Regulation §1.469-5T(a)(7) with respect to the three properties.

Windham's log indicated that she spent less than 100 hours each with respect to the other properties other than the vacant lot. However, the Court was satisfied by Windham's testimony and other evidence that her participation in each of those activities constituted substantially all of the participation in each. Therefore, Windham met the material participation test requirements in Regulation §1.469-5T(a)(2) with respect to these other properties.

That left the vacant lot in which Windham had a 50% ownership interest. She spent approximately 12 hours meeting with an attorney and the other owner of the vacant lot discussing whether to develop or sell the vacant lot. There was nothing in the record about the participation hours of the other owner of the vacant lot. The Court concluded that Windham failed to prove that her participation constituted substantially all of the participation in the activity and that, therefore, Windham did not materially participate in the activity for the vacant lot for 2010.

The Court then considered whether Windham was a real estate professional. It accepted Windham's log and thus determined that she spent 889.25 (901.25 - the 12 from the vacant lot) hours in real property trades or businesses in which she materially participated. Thus, she met the requirement of §469(c)(7)(B)(ii).

The Court then did an analysis pursuant to §469(c)(7)(B)(i) -i.e., whether more than one-half of her personal service hours were in a real property trade or business.

She testified that she went into her brokerage office for 2-1/2 hours a day, five days a week and took no vacations in 2010. That would be a total of 600 hours. The Court found credible Windham's testimony that she took no vacations in 2010. The Court noted that U.S. stock markets were closed on nine days in 2010 and found that Windham did not work in her brokerage office those days. That would reduce her number of hours working as a stock broker to 577.5. Windham's stock broker hours, 577.5, added to her real property hours, 889.25, equals 1,642.75 hours.

IRS argued that Windham did not meet the requirement under §469(c)(7)(B)(i) because she did not include the hours she spent meeting with her brokerage clients at lunches and dinners. Windham provided receipts from her business lunches and dinners. She credibly testified that some were for her brokerage work while others were connected with her rental real estate activities and charities for which she volunteered. The Court said that even if all of the meals were for dinners unrelated to Windham's rental real estate activities - with an average time of two hours - more than half of her personal service hours would still be in a real property trade or business.

The Court found that Windham thus satisfied the requirements of §469(c)(7)(B)(i). Therefore, Windham satisfied both requirements of §469(c)(7)(B) and was a real estate professional. Thus, her rental real estate losses for 2010 were not subject to the §469 passive loss limitations.

Caiping Zang and Tao Liu, TC Memo 2017-55.

The Tax Court has upheld IRS's determination that married taxpayers had unreported income for three years, including wages, rental income, gambling income, and significant advances from a company of which they were sole officers that was largely controlled by the husband's father. The Court rejected their claim that the advances were loans, finding that there were no indications at the time the funds were advanced that the parties intended to create a bona fide debtor-lender relationship.

Gross income is defined as "all income from whatever source derived," including, among other things, compensation for services, rent, and gambling winnings. (§61(a); *Campodonico v. U.S.*, (CA 9 1955) 47 AFTR 847) Gross income includes any funds that the taxpayer receives lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay. (*James v. U.S.,* (S Ct 1961) 7 AFTR 2d 1361)

In determining whether a bona fide loan has occurred, the Tax Court considers:

1. The ability of the borrower to repay;
2. The existence or nonexistence of a debt instrument;
3. Security, interest, a fixed repayment debt, and a repayment schedule;
4. How the parties' records and conduct reflect the transaction;
5. Whether the borrower has made repayments;
6. Whether the lender had demanded repayment;
7. The likelihood that the loans were disguised compensation for services; and
8. The testimony of the purported borrower and lender. (*Kaider*, TC Memo 2011-174)

In cases involving unreported income, IRS bears the initial burden of producing at least minimal evidence linking the taxpayer with the tax-generating activity or the receipt of funds before the general presumption of correctness attaches to a determination. Once IRS produces a minimal evidentiary foundation with respect to the items of unreported income, the burden of persuasion remains with the taxpayer to prove that he or she did not receive the alleged income or that IRS's deficiency calculations were arbitrary or erroneous. (*Rapp v. Commissioner,* (CA 9 1985) 56 AFTR 2d 85-6202)

Caiping Zang and Tao Liu are a married couple who moved from China to the U.S. in 2002. During the years at issue (2006 - 2008), they were employees of Longyuan, a Washington-based import/export business. Longyuan was a wholly owned subsidiary of Qingdao Jiayuan Group Co., Ltd. (Qingdao), a Chinese company that was 96% owned by Liu's father.

During the tax years in issue, Liu and Zang served as Longyuan's sole officers. Zang's responsibilities included overseeing Longyuan's finances, including writing corporate checks, filing corporate tax returns, and maintaining the company's financial records. Liu's responsibilities related more to sales and customer relationships. Longyuan also employed a bookkeeper during this time who assisted Zang in maintaining QuickBooks records for the company.

Longyuan paid Liu and Zang wages. Longyuan's corporate tax returns for each of its fiscal years ending March 31, 2006, 2007, and 2008 reported compensation of $72,000 paid to Zang and $60,000 paid to Liu, which they reported on their jointly filed Form 1040s. However, IRS determined on the basis of cancelled checks that Longyuan actually paid Zang total wages of $83,395, $114,354, and $67,109, respectively, and paid Liu total wages of $67,350, $35,571, and $55,929, respectively.

The taxpayers purchased property to become the offices of Longyuan (Office Property). They leased the Office Property to Longyuan during the tax years in issue and reported rents of $21,000, $38,451, and $68,760, respectively. However, IRS, on the basis of Longyuan's canceled checks, determined that Longyuan actually paid the taxpayers total rents of $32,072, $62,641, and $48,070.

In addition to the wage and rent payments described above, the taxpayers "regularly issued themselves checks" from Longyuan's corporate accounts and made significant cash withdrawals. In total, IRS determined that they received unreported payments of $1.3 million, $870,672, and $129,506 during the tax years in issue, respectively.

The taxpayers gambled frequently and reported gambling winnings of $7.8 million, $5.5 million, and $479,689 for the years at issue, respectively, and losses in excess of their winnings for each year. IRS determined based on third-party information returns that the taxpayers failed to report gambling winnings of $18,419 in 2006 and $25,119 in 2008.

The taxpayers' returns, as well as Longyuan's returns, were prepared by a CPA. The CPA became aware of the substantial amounts that the taxpayers were withdrawing from the corporate accounts for their personal use, and the taxpayers told the CPA that the additional withdrawals were loans. The CPA was concerned that Longyuan would have difficulty continuing business operations unless the amounts were repaid.

In March, 2010, IRS began auditing the taxpayers' returns for the years at issue.

The taxpayers did not execute any promissory notes to Longyuan during the years at issue, but in July, 2010, following the start of IRS's investigation, they executed a note payable to Qingdao for $2.2 million. The note was unsecured and did not provide for a repayment schedule or the payment of interest. They proceeded to write a number of personal checks payable to Longyuan and make three cash deposits into its corporate account over the next few years, as well as "return" their normal salary and rent checks to Longyuan on four occasions.

Sometime between July and November of 2010, the taxpayers provided IRS with a copy of the note to Qingdao. After an IRS agent requested additional documentation showing how the amount of that note had been calculated, the taxpayers provided copies of Longyuan's canceled checks, some of which Zang altered by writing "loan" in the memo line. She made similar alterations in Longyuan's QuickBooks registers.

IRS, using third-party information returns, canceled checks, and other evidence, determined that the taxpayers had unreported wage income, unreported rental income, unreported gambling winnings, and unreported distributions from Longyuan during the years at issue, and determined deficiencies of $448,309, $311,021, and $27,493, respectively. IRS also imposed accuracy-related penalties.

After determining that IRS met its minimum evidentiary foundation such that its deficiency calculations were presumed correct, the Tax Court found that the taxpayers failed to establish that IRS's determinations were erroneous.

With respect to unreported wages and rents, IRS based its determinations on copies of Longyuan's canceled checks issued to the taxpayers that had "salary" or "rent" in the checks' memo lines, and the taxpayers did not provide any evidence that doing so was arbitrary or erroneous. Similarly, the taxpayers did not in any way contradict IRS's transcripts reflecting unreported gambling winnings, and the Court sustained IRS's determinations.

The taxpayers argued that the additional checks they received that were not for wages, rent, or reimbursements, and the cash withdrawals they made from Longyuan's corporate accounts, were loans from the company that should not be included in their gross income. The Tax Court considered the factors outlined in the background above and found that: (1) the taxpayers could not have reasonably expected to be able to repay those amounts based on their regular sources of income; (2) there was no contemporaneous debt instrument; (3) there was no interest, fixed schedule for repayment, or legally enforceable security interests; (4) the parties' conduct and limited records suggested that there was no intent to make loans at the time the funds were advanced, and their conduct following the start of IRS's examination suggested an effort to mislead; (5) limited payments beginning in December 2010 did not support their claim that a debtor-creditor relationship existed at the time the funds were advanced; (6) there was no demand for repayment; (7) the amounts were not disguised compensation; and (8) the taxpayers' testimony was generally self-serving and lacked credibility. Accordingly, the Court agreed with IRS that the additional checks and cash withdrawals were not bona fide loans and should be included in the taxpayers' income.

Given the foregoing, the Court also upheld IRS's imposition of §6662(b)(2) substantial understatement penalties. IRS showed that the understatements of tax for each year at issue were "substantial" within the meaning of §6662(d)(1)(A), and the taxpayers failed to show that the acted reasonably and in good faith.

Zudak, TC Summary Opinion 2017-41.

Taxpayer who organized film festivals was not entitled to deduct losses from that activity, concluding that the deduction was barred by §183 's hobby loss rules. The Court found that, while the taxpayer devoted a significant amount of time to the activity, the overall facts and circumstances, including that the film festival activity never generated a profit and that he did not conduct it in a businesslike manner, showed that he lacked the requisite profit motive.

Under the so-called hobby loss rules, if an activity is not engaged in for profit, deductions generally are disallowed by §183 except to the extent of the gross income derived from the activity for the tax year. To be entitled to business expense deductions without limitation, and avoid being blocked by §183, a taxpayer must show that he engaged in the activity with an actual and honest objective of making a profit. Deductions are not allowable for activities that a taxpayer carries on primarily as a hobby or for recreation. (Regulation §1.183-2(a))

Regulation §1.183-2(b) enumerates nine factors to consider in determining whether a taxpayer has a profit objective. The list is not exhaustive, and no single factor is conclusive. Courts may accord certain factors greater weight than others.

Eric Zudak began working for Trifecta Multimedia, LLC (Trifecta) in 2006. In 2008, Zudak became Trifecta's director of business development. In 2013 (the year at issue), Trifecta paid Zudak wages of $243,224. He traveled extensively for Trifecta, worked long hours, and took little time off.

In 2010, Zudak and some friends organized a production company through which they financed and produced an independent film titled "Karaoke Man." While Marketing Karaoke Man, Zudak attended several small film festivals and found them to be poorly organized and thinly attended. After discussions with a friend and media studies professor, Zudak concluded that cities and towns with a local college or university would be ideal locations for film festivals, which he believed he could successfully Market to college students and faculty. In March 2012, Zudak arranged a college screening of Karaoke Man for students and faculty, followed by a question and answer session with several individuals involved with the film.

In July 2012, Zudak organized US College Film Festival, LLC (CFF), of which he is the sole member. He did not draft a business plan, prepare profit projections, or undertake a formal market analysis for CFF. CFF conducted two film festivals at two different colleges in 2013. At the first, the college provided a theater for screening films free of charge and a number of hotel rooms for festival participants. Before the next one, Zudak had discussions with various individuals and corporate sponsors with the aim of obtaining financial, promotional, and organizational support for CFF. The second film festival screened ten feature-length films (including Karaoke Man) and eight short films and featured a panel discussion of Karaoke Man.

On his timely filed, professionally prepared 2013 return, Zudak reported his $243,224 in Trifecta wages and total tax of $39,041. He attached to his tax return a Schedule C for CFF reporting gross receipts of $690 and expenses of $32,747, resulting in a net loss of $32,057. He did not include a schedule of CFF's expenses with his tax return, but before trial prepared several schedules in an effort to substantiate the expenses, which included among other things transportation and lodging for festival participants, theater rental costs, and website costs. IRS disallowed CFF's expense deductions on the basis that Zudak engaged in the activity as a hobby, without a profit motive.

Zudak also offered copies of Schedules C at trial showing that in 2014, CFF had gross receipts of $29,500, offset by $63,204 in expenses, resulting in a loss of $33,704; and in 2015, CFF had $53,402 in receipts and $55,201 in expenses, resulting in a loss of $1,799.

The Tax Court concluded that Zudak did not conduct the film festival activity in a businesslike manner and he did not engage in the activity with the requisite profit objective during the tax year 2013. Consequently, it upheld IRS's determination that he could not deduct the net loss of $32,057 that he reported on Schedule C for 2013.

The Court considered the following Regulation §1.183-2 factors to determine whether they favored or weighed against a profit motive, and concluded that all but one weighed against Zudak.

a. **Businesslike manner.** The Court found that, while Zudak was able to gather the necessary records in order to identify expenses attributable to CFF's activities, he did not maintain those records in a businesslike manner, and there was no indication that he maintained records with the aim of preparing profit projections, a breakeven analysis, or a formal budget. Against.

b. **Expertise of taxpayer or advisers** Although Zudak had attended a number of film festivals, he had no practical experience organizing or operating one, and there was no indication that the professor-friend that he consulted with had any such experience. Against.

c. **Time and effort.** Although Zudak worked long hours for Trifecta during 2013, the Court found that he devoted much of his free personal time to planning, coordinating, and attending the two festivals that CFF held in 2013. This factor favored Zudak.

d. **Success with similar activities.** Zudak had no prior experience organizing or conducting a film festival or personally managing a small business, so he could not point to any prior success in similar activities. Against.

e. **History of income or loss**. CFF had significant losses in 2013, and did not report an annual profit in either of the following two years for which Zudak offered Schedules C. The Court found that, while Zudak was "optimistic" that CFF will eventually generate profits, its history of losses indicated a lack of profit objective. Against.

f. **Occasional profits.** CFF has produced no profits, only losses. Against.

g. **Financial status**. Zudak was gainfully employed full-time at Trifecta, and his wages-$243,224 in 2013-were the primary source of his income. Against
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h. **Personal pleasure**. The Court found it "evident" that Zudak "enjoys organizing, conducting, and attending film festivals and that he used CFF at least in small part to showcase Karaoke Man-a personal project." Against.

Preamble to Proposed Regulation 01/18/2017; Proposed Regulation §1.2-1, Proposed Regulation §1.2-2, Proposed Regulation §1.3-1, Proposed Regulation §1.21-1, Proposed Regulation §1.32-2, Proposed Regulation §1.63-1, Proposed Regulation §1.63-2, Proposed Regulation §1.152-1, Proposed Regulation §1.152-2, Proposed Regulation §1.152-3, Proposed Regulation §1.152-4, Proposed Regulation §1.152-5, Proposed Regulation §1.6013-1, Proposed Regulation §301.6109-3.

Proposed regulations that would update existing regulations to conform to changes to the Code's definition of "dependent," that would change IRS's position regarding certain matters including the category of taxpayers permitted to claim the childless earned income credit, and that would explain various related concepts in the Code.

The Working Families Tax Relief Act of 2004, P.L. 108-311 (WFTRA) made several changes to the definition of dependent in §152. §152(a) defines a dependent as a qualifying child or a qualifying relative. WFTRA established under §152(c) a uniform definition of a qualifying child. The legislative history identifies five child-related benefits to which the uniform definition applies: the filing status of head of household under §2(b), the child and dependent care credit under §21, the child tax credit under §24, the earned income credit under §32, and the dependency exemption under §151. (H.R. Rep. No. 108-696)

The Fostering Connections to Success and Increasing Adoptions Act of 2008, P.L. 110-351 (FCSIAA) added to the definition of a qualifying child the requirements that the child must be younger than the taxpayer and that the child must not file a joint return (other than as a claim for refund). FCSIAA also amended the rules that apply if two or more taxpayers are eligible to claim an individual as a qualifying child.

The proposed regulations would provide numerous additions and changes to the regulations to conform to WFTRA and FCSIAA. For example:

a. Consistent with the amendments made to §151 and §152 by WFTRA, the proposed regulations would move rules related to the definition of a dependent from the regulations under §151 to the regulations under §152. (Proposed Regulation §1.152-1(a)(1))

b. §152(f)(1)(C) provides that an eligible foster child is included in the definition of "child" and defines the term "eligible foster child." Proposed Regulation §1.152-1(b)(1)(iii) would conform the regulations to that definition.

The proposed regulations would also add to and change existing rules. For example:

a. Dependency exemption-qualifying child and qualifying relative. §152(c)(2) provides that a qualifying child must be a child or a descendant of a child of the taxpayer, or a brother, sister, stepbrother, or stepsister of the taxpayer, or a descendant of any of these relatives. §152(d)(2) provides that a qualifying relative must bear a certain relationship to the taxpayer, which includes a child or a descendant of a child, a brother, sister, stepbrother, stepsister, parent or ancestor of a parent, or an aunt or uncle of the taxpayer.

The proposed regulations would adopt the rule in Notice 2008-5, 2008-1 CB 256, regarding whether an individual is a qualifying child of a taxpayer for purposes of determining whether that individual may be a qualifying relative. That is, the proposed regulations would provide that an individual is not a qualifying child of a person if that person is not required to file an income tax return under §6012, and either does not file an income tax return or files an income tax return solely to claim a refund of estimated or withheld taxes. (Proposed Regulation §1.152-1(a)(2)(i))

b. Dependency exemption-where there are two or more taxpayers eligible for the exemption. §152(c)(4) provides tiebreaker rules that apply if an individual meets the definition of a qualifying child for two or more taxpayers (eligible taxpayers). In general, the eligible taxpayer who is a parent (eligible parent) of the individual may claim the individual as a qualifying child or, if there is no eligible parent, then the individual may be claimed by the eligible taxpayer with the highest adjusted gross income.

The proposed regulations would change the interpretation in Publication 501 (Exemptions, Standard Deduction, and Filing Information) regarding a taxpayer's adjusted gross income on a joint return and provide that, in applying the tiebreaker rules that treat an individual as the qualifying child of the eligible taxpayer with the higher or highest adjusted gross income, the adjusted gross income of a taxpayer who files a joint tax return is the total adjusted gross income shown on the return. This joint return rule also would also be relevant for determining whether §152(c)(4)(C) applies. (Under §152(c)(4)(C), if an eligible parent does not claim an individual as a qualifying child, another eligible taxpayer may claim the individual as a qualifying child only if that taxpayer's adjusted gross income is higher than the adjusted gross income of any eligible parent.) (Proposed Regulation §1.152-2(g)(2))

c. Dependency exemption-adopted and foster children. Proposed Regulation §1.152-1(b)(1)(ii) and Proposed Regulation §1.152-1(b)(1)(iii) would define "adopted child" and "eligible foster child," respectively. Both include the language "placed...by...an authorized placement agency." An old proposed regulation that would be withdrawn by the new proposed regulation contained a definition of "authorized placement agency." The new proposed regulations would change that definition to be a State, the District of Columbia, a possession of the U.S., a foreign country, an Indian Tribal Government (ITG), or an agency or organization that is authorized by any of those bodies or by a political subdivision of any of those bodies, to place children for legal adoption or in foster care. (Proposed Regulation §1.152-1(b)(1)(iv))

d. Dependency exemption-support tests. Under §152(c)(1)(D), to be a taxpayer's qualifying child, an individual must not have provided over one-half of the individual's own support for the calendar year. Under §152(d)(1)(C), to be a taxpayer's qualifying relative, a taxpayer must have provided over one-half of an individual's support for the calendar year.

In applying these rules, the proposed regulations would compare the amount of support provided by the individual or the taxpayer to the total amount of the individual's support from all sources. In general, the amount of an individual's support from all sources includes support the individual provides and income that is excludable from gross income. The proposed regulations would further provide that the amount of an item of support is the amount of expenses paid or incurred to furnish the item of support. If support is furnished in the form of property or a benefit (such as lodging), the amount of that support would be the fair market value of the item furnished. (Proposed Regulation §1.152-4(a)(1))

The proposed regulations would provide that medical insurance premiums are treated as support. These premiums include premiums for Medicare Parts A, B, C and D. However, medical insurance proceeds, including benefits received under Medicare Parts A-D, would not be treated as support and would be disregarded in determining the amount of the individual's support. Thus, only the premiums paid and the unreimbursed portion of the expenses for the individual's medical care would be support. In addition, services provided to individuals under the medical and dental care provisions of the Armed Forces Act would not be treated as support. Neither would payments from a third party (including a third party's insurance company) for the medical care of an injured individual in satisfaction of a legal claim for the personal injury of the individual. (Proposed Regulation §1.152-4(a)(4))

e. Earned income credit. §32 provides a tax credit, the earned income credit (EIC), to eligible taxpayers who work and have earned income below a certain dollar amount. §32(c)(1)(A)(ii) allows a taxpayer without a qualifying child to claim the EIC (childless EIC) if certain requirements are met.

Although there is no regulatory guidance on this issue, IRS has taken the position in IRS Publication 596 (Earned Income Credit) that if an individual meets the definition of a qualifying child for more than one taxpayer and the individual is not treated as the qualifying child of a taxpayer under the tiebreaker rules in §152(c)(4), then that taxpayer is precluded from claiming the childless EIC.

The proposed regulations reflect a change in IRS's position on the interaction of §152(c)(4) and §32. the proposed regulations would provide that, if an individual meets the definition of a qualifying child under §152(c)(1) for more than one taxpayer and the individual is not treated as the qualifying child of one such taxpayer under the tiebreaker rules of §152(c)(4), then the individual also would not be treated as a qualifying child of that taxpayer for purposes of §32(c)(1)(A). Thus, that taxpayer could be an eligible individual under §32(c)(1)(A)(ii) and could claim the childless EIC if he or she met the other requirements of that section. (Proposed Regulation §1.32-2(c)(3)(ii))

The regulations would apply to tax years beginning after the date they are published as final regulations. Pending the issuance of the final regulations, taxpayers may choose to apply these proposed regulations in any open tax years. (Preamble to Proposed Regulation 01/18/2017)

T.D. 9793, 11/09/2016; Regulation §1.6050P-1.

Final regulations that eliminate a rule under which, subject to exceptions, a creditor had to furnish Form 1099-C, Cancellation of Debt, if there was a 36-month period during which the creditor had not received any payment on its indebtedness. This provision has been criticized for confusing taxpayers as to whether and when an actual debt discharge has occurred.

In general, §6050P requires an "applicable entity" to issue an information return if it discharges $600 or more of indebtedness. Applicable entities include governmental entities and financial entities including "any organization a significant trade or business of which is the lending of money." (§6050P(c)(2)(D))

Under Regulation §1.6050P-1(b)(1), indebtedness is deemed discharged solely for purposes of the §6050P reporting obligation only upon the occurrence of an "identifiable event," regardless of whether or not an actual discharge has occurred on or before that date. (Regulation §1.6050P-1(b)(1)) The regulations contain identifiable events that trigger a reporting obligation for a discharge of indebtedness by an applicable entity, seven of which are specific occurrences that result from an actual discharge of indebtedness-e.g., judicial proceedings, an agreement between the debtor and creditor, or the creditor's decision or defined policy to discontinue collection activity. Under the former final regulations, the eighth event-"the 36-month rule"-was the expiration of a "non-payment testing period," which did not necessarily result from an actual discharge of indebtedness. (Former Regulation §1.6050P-1(b)(2)(i)(H))

Under the former final regulations, the non-payment testing period was a 36-month period during which the creditor had not received any payment on the indebtedness. If the testing period expired without payment by the debtor, a rebuttable presumption arose that an identifiable event had occurred, and the creditor had to issue a Form 1099-C. However, the presumption might be rebutted by the creditor, and the creditor was not required to issue a Form 1099-C, if (i) the creditor, or a third party on its behalf, engaged in significant bona fide collection activity at any time during the 12-month period ending at the close of the calendar year; or (ii) the facts and circumstances existing as of January 31 of the calendar year following the expiration of the non-payment testing period indicated that the indebtedness had not been discharged. (Former Regulation §1.6050P-1(b)(2)(iv))

Former Regulation §1.6050P-1(b)(2)(v) provided that, for organizations with a significant trade or business of lending money and agencies other than federal executive agencies, that were required to file information returns pursuant to the 36-month rule in a tax year before 2008, and failed to file them, the date of discharge was the first of the other seven identifiable events, if any, that occurred after 2007.

The fact that a creditor reported under the 36-month rule did not necessarily reflect a discharge of indebtedness. But, a debtor might conclude that the debtor had taxable income even though the creditor had not discharged the debt and continued to pursue collection. Issuing a Form 1099-C before a debt had been discharged might also cause IRS to initiate compliance actions even though a discharge had not occurred.

Additionally, Regulation §1.6050P-1(e)(9) provides that no additional reporting is required if a subsequent identifiable event occurs. Therefore, in cases in which the Form 1099-C was issued because of the 36-month rule but before the debt was discharged, IRS did not subsequently receive third-party reporting when the debt was actually discharged. IRS's ability to enforce collection of tax for discharge of indebtedness income might thus be diminished when the information reporting did not reflect an actual cancellation of indebtedness.

In October of 2014, IRS issued proposed regulations that would remove the 36-month rule, effective and applicable as of the date the proposed regulations were published as final regulations in the Federal Register.

Final regulations that adopt the proposed regulations without change (except for the effective date). Accordingly, the 36-month rule (Former Regulation §1.6050P-1(b)(2)(i)(H)) and related provisions (Former Regulation §1.6050P-1(b)(2)(iv) and Former Regulation §1.6050P-1(b)(2)(v)) are removed. (T.D. 9793, 11/09/2016)

The final regulations are applicable to information returns required to be filed, and payee statements required to be furnished, after December 31, 2016. IRS determined that it was not in the interest of sound tax administration to have the removal of the 36-month rule apply for a portion of a calendar year. Therefore, the final regulations do not adopt the effective/applicability date provision of the proposed regulations.

Information returns required to be filed under §6050P must be filed on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the identifiable event occurs, and payee statements must be furnished on or before January 31 of the year following the calendar year in which the identifiable event occurs. Because the deadline for filing information returns and furnishing payee statements for calendar year 2016 would be after December 31, 2016, the expiration of the 36-month testing period during 2016 does not create a requirement to file information returns and furnish payee statements.

However, Former Regulation §1.6050P-1 (as contained in 26 CFR part 1, revised April 2016) continues to apply to information returns required to be filed, and payee statements required to be furnished, on or before December 31, 2016.

Revenue Ruling 2017-18, 2017-29 IRB; IR 2017-147.

Interest rates for tax overpayments and underpayments for the calendar quarter beginning October 1, 2017 will remain the same as for the third quarter of 2017.

For noncorporate taxpayers, the rate for both underpayments and overpayments for the third quarter of 2017 will be 4%. The 4% rate also applies to estimated tax underpayments for the third quarter in 2017. In addition, the rate of interest on §6603 deposits is 1% for the third calendar quarter in 2017.

April 16, 2016-December 31, 2017 4%
October 1, 2011-April 15, 2016 3%
April 16, 2011-September 30, 2011 4%
January 1, 2011-April 15, 2011 3%
April 16, 2009-December 31, 2010 4%
January 1, 2009-April 15, 2009 5%
October 1, 2008-December 31, 2008 6%
July 1, 2008-September 30, 2008 5%
April 16, 2008-June 30, 2008 6%
January 1, 2008-April 15, 2008 7%
July 1, 2006-December 31, 2007 8%
October 1, 2005-June 30, 2006 7%
July 1, 2005-September 30, 2005 6%
April 16, 2005-June 30, 2005 6%
October 1, 2004-April 15, 2005 5%
July 1, 2004-September 30, 2004 4%
April 16, 2004-June 30, 2004 5%
October 1, 2003-April 15, 2004 4%
January 1, 2003-September 30, 2003 5%
January 1, 2002-December 31, 2002 6%
July 1, 2001-December 31, 2001 7
April 16, 2001-June 30, 2001 8%
July 1, 2000-April 15, 2001 9%
April 16, 2000-June 30, 2000 9%
July 1, 1999-April 15, 2000 8%
April 16, 1999-June 30, 1999 8%
January 1, 1999-April 15, 1999 7%
July 1, 1998-December 31, 1998 8%
April 16, 1998-June 30, 1998 8%
January 1 1998-April 15, 1998 9%
October 1 1997-December 31, 1997 9%
July 1, 1997-September 30, 1997 9%
April 16, 1997-June 30, 1997 9%
January 1, 1997-April 15, 1997 9%
October 1, 1996-December 31, 1996 9%
July 1, 1996-September 30, 1996 9%
April 16, 1996-June 30, 1996 8%
January 1, 1996-April 15, 1996 9%
October 1, 1995-December 31, 1995 9%
July 1, 1995-September 30,1995 9%
April 16, 1995-June 30, 1995 10%
January 1, 1995-April 15, 1995 9%
October 1, 1994-December 31, 1994 9%
July 1, 1994-September 30, 1994 8%
October 1, 1992-June 30, 1994 7%
April 16, 1992-September 30, 1992 8%
January 1, 1992-April 15, 1992 9%
April 16, 1991-December 31, 1991 10%
October 1, 1989-April 15, 1991 11%

For corporations, the overpayment rate for the third quarter of 2017 will be 3%. Corporations will receive 1.5% for overpayments exceeding $10,000. The underpayment rate for the third quarter of 2017 for corporations will be 4%, but will be 6% for large corporate underpayments.

Interest factors for daily compound interest for annual rates of 1.5%, 3%, 4% and 6% are published in Tables 8, 11, 13 and 17 of Revenue Procedure 95-17, 1995-1 CB 556.

Revenue Procedure 2017-37, 2017-21 IRB.

Annual inflation-adjusted contribution, deductible, and out-of-pocket expense limits for 2018 for health savings accounts (HSAs).

Eligible individuals may, subject to statutory limits, make deductible contributions to an HSA. Employers as well as other persons (e.g., family members) also may contribute on behalf of an eligible individual. Employer contributions generally are treated as employer-provided coverage for medical expenses under an accident or health plan and are excludable from income. In general, a person is an "eligible individual" if he is covered under a high deductible health plan (HDHP) and is not covered under any other health plan that is not a high deductible plan, unless the other coverage is permitted insurance (e.g., for worker's compensation, a specified disease or illness, or providing a fixed payment for hospitalization). General purpose health accounts (flexible spending accounts (FSAs)) and health reimbursement arrangements (HRAs) constitute "other coverage" that will generally preclude HSA eligibility. However, exceptions apply for, among other things, limited purpose FSAs and HRAs (those providing only certain benefits, e.g., dental and vision) and FSAs and HRAs imposing high annual deductibles.

HSA distributions not used to pay for qualifying medical expenses generally are included in income and subject to a 10% penalty tax.

For calendar year 2018, the limitation on deductions under §223(b)(2)(A) for an individual with self-only coverage under an HDHP is $3,450 (up from $3,400 for 2017). For calendar year 2018, the limitation on deductions under §223(b)(2)(B) for an individual with family coverage under an HDHP is $6,900 (up from $6,750 for 2017).

For calendar year 2018, an HDHP is defined under §223(c)(2)(A) as a health plan with an annual deductible that is not less than $1,350 (up from $1,300 for 2017) for self-only coverage or $2,700 (up from $2,600 for 2017) for family coverage, and with respect to which the annual out-of-pocket expenses (deductibles, co-payments, and other amounts, but not premiums) do not exceed $6,650 (up from $6,550 for 2017) for self-only coverage or $13,300 (up from $13,100 for 2017) for family coverage.

Revenue Procedure 2017-24, 2017-7 IRB.

Taxpayers who took out Federal student loans to finance attendance at schools owned by American Career Institutes, Inc. (ACI), and whose loans were discharged under the Department of Education's Defense to Repayment or Closed School discharge processes, will not have to recognize gross income as a result of the discharge. IRS further stated that these taxpayers will not be required to increase their taxes or income to account for education credits under §25A, interest deductions under §221, or higher education expense deductions under §222 claimed in respect to payments made with proceeds of these discharged loans. In addition, prior debt relief guidance is modified to provide that IRS will not assert that creditors under the Revenue Procedure must file information returns and furnish payee statements as a result of the discharge relief provided.

The Closed School discharge process allows the Department of Education to discharge a Federal student loan obtained by a student, or by a parent on behalf of a student, who was attending a school at the time it closed or who withdrew from the school within a certain period prior to the closing date. (20 USC 1087(c)) The Defense to Repayment process requires the Department of

Education to discharge a Federal Direct Loan if a student loan borrower establishes, as a defense against repayment, that a school's actions would give rise to a cause of action against the school under applicable state law. (20 USC 1087e(h)) Federal Family Education Loans may also be discharged under this process if certain additional requirements are met.

There is a statutory exclusion from gross income for Federal student loans discharged under the Closed School discharge process. (20 USC 1087e(a)(5)), and a taxpayer whose loan is discharged under this process should not report the amount of the discharged loan in gross income on his or her Federal income tax return.

While there is no statutory exclusion for loans discharged under the Defense to Repayment discharge process, a taxpayer may nonetheless be able to exclude amounts discharged under this process under a provision of the Code or other tax law authorities.

§61(a)(12) provides that gross income includes income from the cancellation of a debt (COD income). There are, however, exceptions under which a taxpayer may not be required to include COD income in gross income. The availability of these exceptions depends on a variety of factors, such as the circumstances of the loan's origination and the borrower's financial situation at the time of the loan's discharge.

One such exception is in §108(a)(1)(B), which provides that a taxpayer may exclude COD income that occurs when the taxpayer is insolvent (the "insolvency exclusion"). A taxpayer is insolvent if all of the taxpayer's liabilities exceed all of the taxpayer's assets immediately before the discharge. Under the insolvency exclusion, a taxpayer is able to exclude the amount of discharged debt from gross income to the extent that the taxpayer's liabilities exceed the fair market value of his or her assets.

In some cases, a discharge may result in an increase in gross income under the tax benefit rule, or an increase in tax liability due to a recapture of credits.

In addition, §6050P requires any applicable entity which discharges the indebtedness (in whole or in part) of any person, to make an information return and furnish a payee statement for that discharge of indebtedness. Regulation §1.6050P-1 provides that reporting is required only upon the occurrence of one of the identifiable events enumerated in the regulations.

In December of 2015, in Revenue Procedure 2015-57, 2015-51 IRB 863, IRS provided that taxpayers who took out Federal student loans to finance attendance at schools owned by Corinthian Colleges, Inc., and whose loans were discharged under the Department of Education’s Defense to Repayment or Closed School discharge processes, will not have to recognize gross income as a result of the discharge. IRS further stated that these taxpayers will not be required to increase their taxes or income to account for education credits under §25A, interest deductions under §221, or higher education expense deductions under §222 claimed in respect to payments made with proceeds of these discharged loans.

IRS has become aware that the Department of Education has begun a process for settling and discharging Federal student loans taken out by taxpayers to finance attendance at a school owned by ACI. The Department of Education has estimated that to date about 4,400 ACI borrowers may be eligible for discharges under this program and that number may increase.

IRS believes that most borrowers whose Federal student loans are taken out to finance attendance at a school owned by ACI whose loans are discharged under the Defense to Repayment discharge process would be able to exclude from gross income all or substantially all of the discharged amounts based on fraudulent misrepresentations made by the colleges to the students, the insolvency exclusion, or another tax law authority. However, determining whether one or more of these exceptions is available to each affected borrower would require a fact intensive analysis of the particular borrower's situation to determine the extent to which the discharged amount is eligible for exclusion under each of the potentially available exceptions. IRS is concerned that such an analysis would impose a compliance burden on taxpayers, as well as an administrative burden on IRS, that is excessive in relation to the amount of taxable income that would result.

IRS has now provided, in Revenue Procedure 2017-24, that it will not assert that a taxpayer who took out Federal student loans to finance attendance at a school owned by ACI, and whose loan was discharged under the Closed School or Defense to Repayment discharge process, must recognize gross income as a result of the Defense to Repayment discharge process. IRS will also not assert that any creditor that is an applicable entity, as defined in §6050P, must file information returns and furnish payee statements under that Code section for the discharge of any indebtedness within the scope of Revenue Procedure 2017-24.

In addition, IRS will not assert that such a taxpayer must increase his:

a. Taxes owed in the year of a discharge, or in a prior year, as a result of either discharge process if in a prior year he received an education credit under §25A attributable to payments made with proceeds of the discharged loan; or

b. Income in the year of the discharge if he or she took: a) a deduction under §221 in a prior year attributable to interest paid on a discharged loan; or b) a deduction under §222 in a prior tax year attributable to payments of qualified tuition and related expenses made with proceeds of the discharged loan.

Revenue Procedure 2017-24 modifies Revenue Procedure 2015-57 to provide that the IRS will not assert that any creditor under that revenue procedure that is an applicable entity, as defined in §6050P, must file information returns and furnish payee statements for the discharge of any indebtedness under that revenue procedure.

Revenue Procedure 2017-24 is effective for tax years beginning on or after January 1, 2016, for Federal student loans to finance attendance at a school owned by ACI that were discharged under the Department of Education's Closed School and Defense to Repayment discharge processes.

Chief Counsel Advice 201719025.

Benefits paid under an employer-provided self-funded health plan for an employee's participation in certain health-related activities did not qualify for exclusion under §104(a)(3) and were thus includible in the employee's income. IRS reasoned that the plan neither involved insurance risk nor had the effect of insurance, and that the amounts received by employees for participating in health-related activities were mostly attributable to employer contributions.

Employer-paid premiums for accident or health insurance coverage are excluded from an employee's gross income under §106(a). Under §105(b), an employee excludes amounts received through employer-provided accident or health insurance if they are paid to reimburse expenses incurred by the employee for medical care (of the employee, the employee's spouse, or the employee's dependents, as well as children of the employee who are not dependents but have not attained age 27 by the end of the tax year) for personal injuries or sickness. To the extent amounts received through employer-provided accident or health insurance are paid without regard to the amount of expenses incurred by the employee for medical care, the amounts are not excluded from gross income because the amounts are not paid to reimburse expenses incurred by the employee for personal injuries and sickness.

Amounts received through accident or health insurance for personal injuries or sickness are generally excluded from gross income under §104(a)(3). This exclusion does not apply, however, if the amounts are either (1) attributable to contributions by the employer that were not includible in the gross income of the employee or (2) paid by the employer. The legislative history underlying §104(a)(3) provides that, for the exclusion to apply, the arrangement must be insurance (i.e., with adequate risk shifting) or must have the effect thereof.

Regulation §1.104-1(d) provides that if an individual purchases a policy of accident or health insurance out of the individual's own funds, amounts received thereunder for personal injuries or sickness are excludable from gross income under §104(a)(3). This exclusion also applies to amounts received by an employee for personal injuries or sickness from a fund which is maintained exclusively by employee contributions. (Regulation §1.104-1(d)) However, if an employer is either the sole contributor to such a fund, or is the sole purchaser of a policy of accident or health insurance for its employees, the exclusion does not apply to any amounts received by the employees through such fund or insurance. (Regulation §1.104-1(d))

Under the §125 cafeteria plan rules, an employee's salary reduction applied to buy health insurance coverage is not included in gross income, and the coverage is excluded under §106 as employer-provided accident or health coverage.

Promoters (typically product developers or insurance brokers) sell self-funded health plans (often referred to by promoters as "fixed indemnity health plans," described by the CCA as plans that pay covered individuals a specified amount of cash for the occurrence of certain health-related events) and wellness plans to employers. The plans are promoted as a way to provide certain benefits to employees at no or little cost to either the employer or employees.

The plans purport to provide the following benefits:

a. Employees who voluntarily participate make pre-tax contributions to the wellness plans and relatively small after-tax contributions to the self-funded health plans. A large portion of the pre-tax contributions are returned to the employees as cash payments from the self-funded health plans or rewards through the wellness plans-which are purportedly not includible in income.

b. The pre-tax contributions to the wellness plans lower the amount of Federal Insurance Contributions Act (FICA) taxes that are owed by the employees and the employers, and the cash payments that are made to the employees from the plans are treated as not includible in income or wages.

c. The employer pays a fee to the promoter for administering the plans, the amount of which is generally less than the FICA taxes that otherwise would have been paid, purportedly allowing the employer to provide a health plan and a wellness plan to its employees at no (or little) cost.

The CCA provided two illustrative factual situations:

a. **Situation 1**. An employer provided all employees, regardless of enrollment in other comprehensive health coverage, the option to enroll in coverage under a self-funded health plan. Participants paid a small after-tax employee contribution and were paid a significantly larger fixed cash payment benefit for participating in certain health-related activities. The participants did not pay for the activity, and the cash benefit could be received for up to 12 activities per year. Under an actuarial analysis, all employees were expected to receive benefit payments under the self-funded health plan that markedly exceeded their after-tax premium payments, and in practice, all (or nearly all) employees received payments from the plan that exceeded their after-tax contributions.

b. **Situation 2.** The facts are the same as Situation 1, except the employer also provided employees with the ability to enroll in coverage under a wellness plan which would independently qualify as an accident and health plan under §106. Participants in the wellness plan paid a pre-tax employee contribution through a §125 cafeteria plan. The wellness plan provided participants with health-related wellness activities at no charge to the employees. Typically, if the employee's net take-home pay after receiving the fixed cash payment from the self-funded health plan exceeded the amount of the employee's net take-home pay prior to implementing the plans, the wellness plan provided that the excess was paid in the form of flex credits that could be used for benefits under the §125 cafeteria plan such that the net take-home pay of each employee who participated in the plans generally remained unchanged.

The CCA concluded that the employer-provided self-funded plan did not qualify for exclusion under §104(a)(3), which applies to amounts received through accident or health insurance (or an arrangement having that effect). While neither the Code nor the regulations define the term "insurance," the Supreme Court has explained that, in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be involved. (*Helvering v. Le Gierse,* (S Ct 1941) 25 AFTR 1181) The risk transferred must be the risk of economic loss. (*Allied Fidelity Corporation v. Commissioner,* (CA 7 1978) 41 AFTR 2d 78-1044) The risk must contemplate the fortuitous occurrence of a stated contingency (*Commissioner v. Treganowan,* (CA 2 1950) 39 AFTR 672), and must not be merely an investment or business risk. (Le Gierse)

As applied to Situation 1, the CCA observed that, while the participants received a payment for engaging in certain activities related to health, the arrangement did not involve a risk of economic loss or fortuitous event. Accordingly, there was no insurance for federal income tax purposes. Similarly, because there was no insurance risk, there was no "risk shifting," so the arrangement did not "have the effect of insurance." Accordingly, amounts received through the plan were not excluded from income under §104(a)(3).

In addition, the CCA found that, because the average benefits paid or predicted to be paid through the self-funded health plan significantly exceeded the after-tax contributions paid by a participating employee, the benefits in excess of the premiums were either attributable to contributions by the employer that were not includable in the gross income of the employee or paid by the employer-and thus ineligible for exclusion under §104(a)(3).

In Situation 2, the result was the same for the self-funded health plan. However, the flex credits awarded under the wellness plan were excluded from the income of a participating employee unless used to purchase taxable benefits under the §125 cafeteria plan, such as whole life insurance coverage or a gym membership. In that instance, the flex credits used to purchase the taxable benefits under the §125 cafeteria plan were included in the gross income and wages of the participating employee.

Chief Counsel Advice 201652020.

There is no distinction between tangible and intangible consumer products in determining whether workers who qualify as direct sellers may be treated as independent contractors, even though there is a proposed federal regulation that makes such a distinction.

Workers who qualify as direct sellers are treated as independent contractors for federal income and employment tax purposes, without regard to the common-law test. (§3508(a)) These individuals are commonly referred to as "statutory nonemployees." As statutory nonemployees, direct sellers are not subject to federal income tax withholding, federal social security and Medicare taxes, or federal unemployment tax.

In general, workers may qualify as direct sellers if: (1) substantially all the compensation paid for their services as direct sellers is directly related to sales or other output rather than the number of hours worked, (§3508(b)(2)(B)) and (2) their services are performed under a written contract that states they will not be treated as employees. (§3508(b)(2)(C)) In addition, to qualify as a direct seller, a person must be engaged in certain, specified business or trade activities, including the trade or business of selling (or soliciting the sale of) consumer products to any buyer on a buy-sell basis, a deposit-commission basis, or any similar basis, for resale (by the buyer or any other person) in the home or otherwise than in a permanent retail establishment. (§3508(b)(2)(A))

In 1986, IRS issued Proposed Regulation §31.3508-1, which defined a consumer product, for purposes of §3508, as any tangible personal property which is distributed in commerce and which is normally used for personal, family, or household purposes (including any such property intended to be attached to or installed in any real property without regard to whether it is so attached or installed).

The proposed federal regulation has never been adopted.

In 1992, the court in *Cleveland Institute of Electronics, Inc.*, (DC OH 1992) 69 AFTR 2d 92-1015, ruled that sales people who marketed a taxpayer's direct-mail educational courses should be treated as direct sellers for tax purposes. IRS had argued that the sales people did not meet the test for independent contractor status under §3508, because the educational courses which the sales persons were selling did not qualify as "consumer products." IRS believed that only tangible goods qualified as consumer products and that by selling a course of education, the sales persons were selling an intangible service and not tangible goods.

The district court reached its ruling after concluding that the purpose originally behind §3508 was to reduce the number of controversies regarding employment tax status and to improve tax compliance on the part of independent contractors. To the court, it was clear that the purpose behind §3508 was best advanced if the term "consumer products" is construed to include both tangible consumer products and intangible consumer services. The court also noted that the proposed 1986 regulation, even though it was six years old at the time of the ruling, still had not been issued in its final form.

In the CCA, IRS cited the district court's ruling in *Cleveland Institute of Electronics, Inc.*, and said the ruling eliminates the distinction between tangible and intangible consumer products in Proposed Regulation §31.3508-1. IRS also noted that the latest advice it was aware of was in Chief Counsel Advice 199940006, which cites to 1996 training materials stating that "cases should not be developed based on a distinction between tangible and intangible products; i.e., both types of products will qualify."

Chief Counsel Advice 201645012.

An amount that an employee could have elected to receive as salary may be treated as subject to a substantial risk of forfeiture under §409A if the employer provides a matching contribution resulting in a 25% increase in the present value of the amount deferred. The increased salary was "materially greater," as provided in Regulation §1.409A-1(d)(1), than the employee otherwise could have elected to receive absent such risk of forfeiture.

All amounts deferred under a nonqualified deferred compensation plan for all tax years are currently includible in income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless the plan: (a) meets the distribution, acceleration of benefit, and election requirements under §409A; and (b) is operated in accordance with them. (§409A(a)(1)(A)) Noncompliance results in inclusion in income for all amounts deferred under the plan by a participant, an interest charge (at the underpayment rate plus one percentage point), and an additional 20% tax. (§409A(a)(1)(B))

Regulation §1.409A-1(d)(1) provides that a substantial risk of forfeiture exists if the receipt of deferred compensation is conditioned on the performance of substantial future services or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. In general, the addition of any risk of forfeiture after the legally binding right to the compensation arises, or any extension of a period during which compensation is subject to a risk of forfeiture, is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. However, an amount will be considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the amount of compensation if the present value of the amount subject to a substantial risk of forfeiture is "materially greater" than the present value of the amount the recipient otherwise could have elected to receive absent such risk of forfeiture.

On November 1, 2014, an employee entered into an agreement to defer $15,000 of the employee's salary that would otherwise have been paid during 2015, with payment of the deferred amount to be made as a lump-sum payment on January 1, 2018, but only if the employee continues to provide substantial future services until December 31, 2017. Under the agreement, the employee's salary is reduced by $600 each biweekly pay period (i.e., 26 × $600, or $15,600) and the employer credits matching amounts to the employee's deferred compensation account of 25% of each salary reduction (i.e., 26 × ($600 ÷ 4), or $3,900) for a total amount deferred of $19,500. The matching amounts are credited each time a salary reduction amount is credited, which is the time the salary reduction amount would otherwise be paid as salary.

In the CCA, IRS determined that the salary that the employee could have elected to receive as compensation would be treated as subject to a substantial risk of forfeiture under §409A through December 31, 2017, if, as part of the imposition of the service requirement through December 31, 2017, the employer provides a matching contribution resulting in a 25% increase in the present value of the amount of deferred compensation.

IRS reasoned that generally, under Regulation §1.409A-1(d), the addition of a risk of forfeiture is disregarded. However, the addition of a substantial risk of forfeiture is respected if the present value of the amount subject to the substantial risk of forfeiture is "materially greater" than the present value of the amount the service provider otherwise could have elected to receive absent such risk of forfeiture.

Under the facts here, the present value of the amount deferred by the employee is 25% greater than the amount the employee otherwise could have received absent the addition of the substantial risk of forfeiture. IRS found that a 25% increase in the present value of the amount a service provider could have received absent the risk of forfeiture was a material increase.

Accordingly, IRS concluded that the combined deferred amount of 2015 salary ($15,600) plus the deferred amount of the employer's matching contribution ($3,900) was subject to a substantial risk of forfeiture for purposes of §409A until December 31, 2017.

PLR 201707007.

Income, gift and estate tax consequences of a husband, under a divorce agreement, transferring stock to a trust with respect to which his wife had an income interest and he had a reversionary interest.

Under §1041(a), no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse or a former spouse, but only if the transfer is incident to a divorce.

§1041(b) provides that, in the case of any transfer of property described in §1041(a), the property is treated as acquired by the transferee by gift.

For purposes of §1041(a)(2), a transfer of property is incident to the divorce if the transfer occurs (1) within one year after the date on which the marriage ceases, or (2) is related to the cessation of the marriage. (§1041(c))

A transfer of property is related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument, as defined in §71(b)(2), and the transfer occurs not more than six years after the date on which the marriage ceases. (Regulation §1.1041-1T(b), Q&A 7) A divorce or separation instrument includes a modification or amendment to such decree or instrument.

§2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration is deemed a gift.

Where a husband and wife enter into a written agreement relative to their marital and property rights, and divorce occurs within the three-year period beginning on the date one year before the agreement is entered into (whether or not the agreement is approved by the divorce decree), any transfers of property or interests in property made pursuant to the agreement (1) to either spouse in settlement of his or her marital or property rights, or (2) to provide a reasonable allowance for the support of issue of the marriage during minority, will be deemed to be transfers made for a full and adequate consideration in money or money's worth. (§2516)

Under §2702(a)(1), solely for purposes of determining whether a transfer in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any interest in such trust retained by the transferor or by any applicable member of the transferor's family (as defined in §2701(e)(2)) is determined as provided in §2702(a)(2). §2702(a)(2)(A) provides that the value of any retained interest which is not a qualified interest is treated as zero.

The term "retained" means held by the same individual both before and after the transfer in trust. (Regulation §25.2702-2(a)(3)) In the case of the creation of a term interest, any interest in the property held by the transferor immediately after the transfer is treated as held both before and after the transfer.

§2702(a)(3)(A)(iii) provides that §2702(a) does not apply to any transfer to the extent that regulations provide that such transfer is not inconsistent with the purposes of §2702.

Regulation §25.2702-1(c)(7) provides that §2702 does not apply to a transfer in trust if the transfer of an interest to a spouse is deemed to be for full and adequate consideration by reason of §2516 (relating to certain property settlements) and the remaining interests in the trust are retained by the other spouse.

Regulation §25.2702-4(d), Example 5, considers a situation where H and W enter into a written agreement relative to their marital and property rights that requires W to transfer property to an irrevocable trust, the terms of which provide that the income of the trust will be paid to H for 10 years. On the expiration of the 10-year term, the trust is to terminate and the trust corpus is to be paid to W. H and W divorce within two years after the agreement is entered into. Pursuant to §2516, the transfer to H would otherwise be deemed to be for full and adequate consideration. §2702 does not apply to the acquisition of the term interest by H because no member of H's family acquired an interest in the property in the same transaction or series of transactions. The result would not be the same if, on the termination of H's interest in the trust, the trust corpus were distributable to the children of H and W rather than W.

Under §2036(a)(1), the value of property that a decedent has transferred into trust will be includible in that decedent's estate if he has retained the possession or enjoyment of, or the right to the income from, the property for any period not ascertainable without reference to his death. Under §2036(a)(2), the value of property that a decedent has transferred into trust will be includible in that decedent's gross estate where he has retained the right, alone or in conjunction with any person, to designate the persons who will possess or enjoy the property or income therefrom.

Regulation §20.2036-1(b)(1)(ii) provides that a reservation by the decedent "for any period not ascertainable without reference to his death" includes a situation where a decedent reserved the right to receive the income, annuity, or other payment from transferred property after the death of another person who was enjoying the income, annuity, or other payment at the time of the decedent's death. In such case, the amount to be included in the decedent's gross estate under §2036(a)(1) does not include the value of the outstanding interest of the other person.

Regulation §20.2031-7 provides information to calculate the present value of certain interests that are dependent upon life or a term of years.

Pursuant to their divorce, Husband and Wife negotiated a proposed settlement agreement regarding marital support obligations and property rights. Husband proposes to transfer Company shares to an irrevocable trust for the benefit of Wife. Under the terms of the trust, Wife will receive all net income from the trust during life and may, at the discretion of the trustee, receive distributions of principal. The trustee may not, however, distribute shares to Wife nor sell such shares in order to make cash distributions to Wife. At the death of Wife, any remaining trust principal will be distributed to Husband, or, should Husband predecease Wife, Husband's estate.

Husband will transfer the shares of Company to the trust within six years after the entry of the final judgment of divorce. In return, Wife will relinquish all marital rights and property claims that she acquired while married to Husband. This arrangement is to be formalized in a legally binding property settlement agreement between Husband and Wife prior to the transfer of Company shares to the trust.

The ruling concluded that, under the §1041 rules, Husband will not recognize gain or loss on the transfer of Company shares to the trust.

Assuming a final judgment of divorce occurs within the 3-year period beginning on the date one year before the agreement is entered into, Husband's transfer to the trust will constitute a transfer for full and adequate consideration under §2516 and will not be considered a taxable gift by Husband to anyone.

And, after noting that the transfer of the property to Trust is deemed to be for full and adequate consideration under §2516, IRS noted that Husband will retain the entire remainder interest in Trust by reason of the reversion. Accordingly, §2702(a) will not apply for purposes of determining whether

Husband's transfer to Wife of the term interest in the trust is a gift or for purposes of determining the value of such transfer.

In this case, the trust provides that upon Wife's death, the remaining trust principal will revert to Husband, or to Husband's estate if Husband predeceases Wife. Therefore, if Husband survives Wife, §2036(a)(1) will apply to require inclusion of the trust property in Husband's gross estate.

Husband retained the power described in §2036(a)(2) over the trust property for his life. Therefore, if Husband predeceases Wife, §2036(a)(2) will apply to require inclusion of the trust property in Husband's gross estate.

Accordingly, the fair market value of the trust property on Husband's date of death (or the alternate valuation date, as the case may be), reduced by the fair market value of Wife's outstanding term interest (determined in accordance with the valuation tables of Regulation §20.2031-7), will be includible in Husband's gross estate upon his death under §2036(a)(1) and §2036(a)(2).

PLR 201705003.

The investments of certain insurance dedicated portfolio funds will not cause holders of variable life insurance policies that are associated with those funds, to be considered the owners of such funds for tax purposes; IRS found that there were insufficient incidents of ownership to warrant such treatment.

In general, the holder of legal title is the owner of the property and is taxed on the income derived from the property. However, if a person other than the holder of legal title possesses the "benefits and burdens" of ownership, that person is attributed ownership of property for tax purposes. (*Frank Lyon Co. v. U.S.* (Sup Ct 1978) 41 AFTR 2d 78-1142)

The "investor control" doctrine provides that, if a policyholder has sufficient "incidents of ownership" over the assets in a separate account underlying a variable life insurance or annuity policy, the policyholder, rather than the insurance company, will be considered the owner of those assets for federal income tax purposes, despite the company's retention of possession of and legal title to the assets. A critical incident of ownership is the power to decide what specific investments will be held in the account. (Revenue Ruling 82-54, 1982-1 CB 11) Other incidents of ownership include the powers to vote securities in the separate account; to exercise other rights or options relative to these investments; to extract money from the account by withdrawal or otherwise; and to derive, in other ways, what the Supreme Court has termed "effective benefit" from the underlying assets. (*Griffiths v. Helvering,* (S Ct 1939) 23 AFTR 784) The determination of whether the holder of a variable life insurance policy or contract has sufficient incidents of ownership over the assets to warrant treatment as an owner depends on all relevant facts and circumstances. (Revenue Ruling 2003-91, 2003-2 CB 347)

If the separate account assets underlying a variable contract are considered the assets of the life insurance company that issues the contract and not the property of the contract holder, §817 governs the tax treatment of the contract. If the separate account assets underlying the contract are considered the assets of the contract holder, the contract holder is currently taxed on any income and gains attributable to the underlying assets under §61.

Observation: Where the policyholder is treated as the owner of the investments, the income from the investments is not considered to be derived under a life insurance contract. This means that the policyholder is taxed on the interest (or dividends) in the year in which the amounts are earned, without the benefit of any deferral.

§4982(a) imposes a tax on every regulated investment company (RIC) for each calendar year, that is equal to 4% of the excess (if any) of: (1) the required distribution for such calendar year, over (2) the distributed amount for such calendar year. However, §4982(f)(2) and §4982(f)(4) provide exemptions from the excise tax for any calendar year if, at all times during such calendar year, each shareholder in such company was a segregated asset account of a life insurance company held in connection with variable contracts (as defined in §817(d)) or another RIC described in §4982(f).

§817 defines the term "variable contract" to mean a contract that (1) provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company; (2) provides for the payment of annuities, is a life insurance contract, or provides for funding of insurance on retired lives, as described in §807(c)(6); and (3) satisfies additional requirements in §807(c), including requirements to reflect the current investment return and market value of the segregated asset account.

Trust is a statutory trust, which is registered with the Securities and Exchange Commission (SEC) as an open-end management investment company under the Investment Company Act of 1940 (1940 Act) and currently has multiple series, each with a different investment objective and strategy. Trust receives investment advisory services from a registered investment advisor under the 1940 Act (Advisor). Each series of Trust is or will be an insurance dedicated fund that is offered exclusively to insurance company segregated asset accounts to serve as an investment vehicle for life insurance and variable annuity contracts purchased by individuals. The life insurance companies whose segregated asset accounts hold shares of the series of Trust are life insurance companies within the meaning of §816(a).

Portfolios A, B, and C (collectively, the Portfolios) are existing series of Trust. The shares of the Portfolios are registered with the SEC under the Securities Act of 1933, as amended. The Portfolios have made or intend to make elections to be treated (and intend to continue to qualify) as RICs.

Each portfolio has a specific investment objective. A and B intend to invest in equity and fixed income passive index RICs. These investments will be both series of the Trust and publicly available funds. C intends to invest in fixed income securities through series of the Trust and publicly available funds.

A and B propose allocating the assets of each among large cap U.S. stocks, U.S. fixed income securities, non-U.S. stocks, non-U.S. fixed income securities, and small- and mid-cap U.S. stocks. C intends to invest in a mix of global fixed income securities-some U.S. and some non-U.S. Each of the Portfolios will comply with the diversification requirements of §817(h) and Regulation §1.817-5(b).

The Portfolios are insurance dedicated funds that serve as investment vehicles for life insurance and variable annuity contracts purchased by individuals (Variable Contracts). Except as otherwise permitted by Regulation §1.817-5(f)(3), all shares of the Portfolios and of the Portfolio investments that are series of the Trust are held by segregated asset accounts underlying variable contracts of one or more life insurance companies. Each segregated asset account that will hold shares of a Portfolio will be a separate account registered with the SEC as a unit investment trust under the 1940 Act or will be exempt from registration under the 1940 Act. The life insurance companies whose segregated asset accounts hold shares of Portfolio are life insurance companies within the meaning of §816(a). Except as otherwise permitted by Regulation §1.817-5(f)(3), public access to the Portfolios and to the Portfolio investments that are series of the Trust will be available exclusively through the purchase of a variable contract within the meaning of §817(d).

The Variable Contracts are variable contracts within the meaning of §817(d). In general, various insurance companies will hold the premiums paid by a Variable Contract holder, net of any fees or commissions, and any income earned on the net premiums, in a segregated asset account. A Variable Contract holder will be able to allocate Variable Contract premiums and amounts held in the segregated asset account among several different investment options or subaccounts that correspond to the variable investment options under the holder's Variable Contract. At least one subaccount will correspond to an investment in a particular Portfolio.

All investment decisions concerning each Portfolio will be made solely by Adviser. Variable Contract holders will have no current knowledge of a Portfolio's specific asset composition, but Portfolio's holdings will be available as permitted by the SEC. A Variable Contract holder will have no legal, equitable, direct or indirect interest in any Portfolio asset.

IRS ruled, as requested, that the investment assets of the Portfolios will not cause a Variable Contract holder to be considered the tax owner of such Portfolios and each Portfolio will be eligible for the exception from the excise tax imposed by §4982.

IRS reasoned that the Variable Contract holders in this case do not have any control of the investments of the Portfolios, including the respective Portfolio's investment in public available funds. The investment decisions of the Portfolios are made by Adviser in its sole and absolute discretion and are subject to change without notice to or approval by the Variable Contracts holders. The Variable Contract holders do not have any more control over the assets held under their contract than was the case in Revenue Ruling 82-54 or Revenue Ruling 2003-91, and the Portfolios are not an indirect means of allowing a Variable Contract holder to invest in public funds. Accordingly, IRS reasoned that the Variable Contract holders did not possess sufficient incidents of ownership over the assets to warrant treating them as the owners of such assets for tax purposes.

PLR 201648001.

Payments of spousal support were not alimony payments under §71(b) because the payments did not terminate on the death of the payee spouse. The support agreement was not saved by a State law (Minnesota) provision which generally provided that, unless otherwise agreed in writing or expressly provided in the decree, the obligation to pay future maintenance terminated upon the death of either party or the remarriage of the party receiving maintenance.

Alimony payments are includible in the recipient's gross income under §71(a) and deductible by the payor under §215(a). An alimony or separate maintenance payment is one that meets the following four requirements:

1 The payment must be made under a divorce or separation instrument;

2. The instrument must not designate the payment as not includable in the recipient spouse's gross income under §71 and not deductible by the payor spouse under §215;

3. Legally separated spouses under a decree of divorce or separate maintenance must not be members of the same household when the payments are made; and

4. The payor's obligation to make the payment must end at the death of the payee spouse. (§71(b)(1))

Regulation §1.71-1T(c), Q&A 16, provides that a payment will be treated as child support, not alimony, if the payment is reduced (a) on the happening of a contingency relating to a child of the payor, or (b) at a time which can clearly be associated with such a contingency. Regulation §1.71-

1T(c), Q&A 17, provides that a contingency relates to a child of the payor if it depends on any event relating to that child, regardless of whether such event is certain or likely to occur. Events that relate to the child of the payor include the following: the child's attaining a specified age or income level, dying, marrying, leaving school, leaving the spouse's household, or gaining employment.

In addition, under Regulation §1.71-1T(c), Q&A 18, where the payments are to be reduced not more than six months before or after the date the child is to attain the age of 18, 21, or the local age of majority, such payments which would otherwise qualify as alimony or separate maintenance payments, will be presumed to be reduced at a time clearly associated with the happening of a contingency relating to a child of the payor.

Minn. Stat. §518.552 discusses the requirements to be awarded maintenance including the grounds, the amount and duration, and reopening maintenance awards. Subdivision 5 provides:

The parties may expressly preclude or limit modification of maintenance through a stipulation, if the court makes specific findings that the stipulation is fair and equitable, is supported by consideration described in the findings, and that full disclosure of each party's financial circumstances has occurred. The stipulation must be made a part of the judgment and decree.

Minn. Stat. §518.64 Subd. 3, provides that "Unless otherwise agreed in writing or expressly provided in the decree, the obligation to pay future maintenance is terminated upon the death of either party or the remarriage of the party receiving maintenance."

In *Karon v. Karon,* (Minn. 1989) 435 N.W.2d 501, the parties agreed the husband would pay maintenance to the wife, she would not pay maintenance to him, and the court was divested from having any jurisdiction to award any other maintenance. The Minnesota Supreme Court held that the parties' agreement to waive the court's continued jurisdiction (sometimes referred to as a Karon waiver) was valid and that the court therefore could not modify the original dissolution decree.

In *Butt v. Schmidt,* (Minn. 2008) 747 N.W.2d 566, the court looked at the requirements of Karon and Minn. Stat. §518.552 Subd. 5, and held that four requirements must be met before a stipulation precluding or limiting maintenance modification divests the court of its jurisdiction over maintenance: (1) the stipulation must include a contractual waiver of the parties' rights to modify maintenance; (2) the stipulation must expressly divest the district court of jurisdiction over maintenance; (3) the stipulation must be incorporated into the final judgment and decree; and (4) the court must make specific findings that the stipulation is fair and equitable, is supported by consideration described in the findings, and that full disclosure of each party's financial circumstances has occurred.

In *Telma v. Telma,* (Minn. 1991) 474 N.W.2d 322, the husband argued that his obligation to pay maintenance to his ex-wife should be terminated because of her remarriage in reliance on Minn. Stat. §518.64 Subd. 3. The parties' agreement was that the ex-wife was to receive spousal support in the amount of $1,200 per month for five years with the award to be terminated on the earlier of two stated contingencies: the expiration of the 5-year period or the ex-wife's adjusted gross income exceeding $30,000 per year. The husband specifically waived any right to have the court modify his obligation to pay maintenance, either as to amount or duration or termination. The court held that while in *Gunderson v. Gunderson,* (Minn. 1987) 408 N.W.2d 852, it held that Subd. 3, required that a marital dissolution clause decree expressly state that maintenance will continue beyond remarriage, it did not foreclose the consideration of clear written expressions of the parties' intention in this regard as ascertained from their agreement as a whole. The court held the husband must continue to pay maintenance until the earlier of the two stated contingencies.

In *Young v. Young,* (Minn. Ct. App. 2003) 2003 Minn. App. LEXIS 1283, the court held that the husband's spousal-maintenance obligation may not be terminated upon the ex-wife's remarriage even though the maintenance provision does not state that maintenance will continue beyond remarriage, because the parties agreed to divest the court of jurisdiction to modify the maintenance award and no event that allows termination under the judgment has occurred.

Taxpayer and Ex-spouse were married with children. Ex-spouse filed a proceeding to dissolve the marriage. Ex-spouse and Taxpayer orally reached a settlement on the record before the court. The court ordered Ex-spouse's counsel to submit Findings of Fact, Conclusions of Law, Order for Judgment, and Judgment and Decree in conformity with the oral settlement, which the court then executed and under which the parties' marriage was dissolved. Child custody, visitation and support were also determined; property was awarded; and spousal support was determined.

Most of the specifics of the spousal support arrangement were redacted in the PLR. It apparently provided for monthly payments of a specified amount for a specified period. But whatever payment terms the support agreement contained, it did not expressly state whether Ex-spouse's liability would end upon Taxpayer's death. The support agreement also contained a provision divesting the court of any further jurisdiction with regard to the support payments.

In addition, Ex-spouse was ordered to maintain a life insurance policy in an amount sufficient to cover his maintenance and child support obligations.

IRS privately ruled that the payments of spousal support were not alimony payments under §71(b).

IRS reasoned that in the instant case, the court-ordered monthly spousal maintenance payments did not meet the definition of alimony §71(b)(1). Although the other three of the four requirements for designating the payments as alimony were satisfied, the requirement that the payments terminate on the death of the payee spouse was not. Even though the Findings of Fact, Conclusions of Law, Order for Judgment, and Judgment and Decree did not expressly state that Ex-spouse's liability would not end upon Taxpayer's death, the parties agreed the court would not have jurisdiction to consider modification of the award in accordance with Karon, Young, Butt and Minn. Stat. §518.552 Subd. 5. Therefore, Ex-spouse's obligation to pay maintenance payments to Taxpayer would continue for the specified number of months and would not be terminated upon her death, see *Telma* and *Young*. Accordingly, the maintenance payments did not qualify as alimony under §71(b).

Observation: Although it is not entirely clear because of the facts deleted in the PLR, IRS has apparently concluded that, under Minn. Stat. §518.64 Subd. 3, as interpreted by Young, a Karon waiver (depriving the court of continuing jurisdiction) satisfies the "otherwise agreed in writing or expressly provided in the decree" condition and that, therefore, there was nothing that terminated the obligation to pay future maintenance upon Taxpayer's death or remarriage.

IRS also considered whether there was a presumption that the payments were child support. Under Regulation §1.71-1T(c), Q&A 18, there was a presumption that the payments were child support if they ended within six months before or after the date the children turn 18 or the local age of majority. Pursuant to the Findings of Fact, Conclusions of Law, Order for Judgment, and Judgment and Decree, the maintenance payments were payable over a specified month period beginning on Date 4. The children will turn 18 on Date 6. The maintenance payments would end on Date 7 (apparently a date more than 6 months after the children turn 18). Thus, IRS concluded that the spousal maintenance payments were not presumed to be child support.

Legal Advice Issued by Field Attorneys 20171202F.

Discounts provided by a company to non-employee individuals designated by its employees do not qualify for nontaxable fringe benefit treatment and are thus taxable to the designating employees. The LAFA further concluded that the company failed to provide sufficient evidence that IRS should use a price other than the "published price" in determining whether the employee discount exceeded the 20% limit under §132(c)(1)(B).

§132(a)(2) excludes from gross income the fringe benefit of qualified employee discounts. An employee for purposes of §132(a) is defined as an individual currently employed by the employer, an individual who retired from the employer, or became disabled while working for the employer, or a widow or widower of any one of these. (§132(h)) And, spouses and dependent children of the above mentioned groups are treated as employees for purposes of §132(a)(2). (§132(h)(2))

In general, a qualified employee discount is any employee discount with respect to qualified property or services to the extent that the discount does not exceed certain limits-for services, 20% of the price at which the services are offered to its customers. (§132(c)(1)(B)) If a discount exceeds 20%, then the excess is includable in the employee's income. (Regulation §1.132-3(e)) Qualified services are those which are offered to customers in the ordinary course of the line of business of the employer in which the employee is performing services. (§132(c)(4))

The price at which services are offered to customers at the time of the employee's purchase is generally controlling for purposes of determining the extent of the discount. (Regulation §1.132-3(b)(1)) Any quantity discounts offered by the employer to customers are not taken into account unless the employee actually buys the requisite quantity to trigger such a discount. (Regulation §1.132-3(b)(2)(ii)) Where an employer offers property or services to certain "discrete" customer groups (e.g., members of a professional association) at a "discounted price," and sales at these discounted prices comprise at least 35% of the employer's gross sales for a representative period (i.e., the employer's tax year immediately preceding the tax year in which the service is provided to the employee at a discount), the amount of any employee discount offered with respect to that property or those services is the difference between (1) the "discounted price," and (2) the price at which employees may buy the property or services. (Regulation §1.132-3(b)(2)(iv)) Special rules apply to determine the "discounted price" when there are various levels of discounts offered to different customer groups.

Under §3501(b), taxes imposed with "respect to non-cash fringe benefits shall be collected (or paid) by the employer."

Company provides its employees a discount program (Program) under which they may designate a certain number of individuals, including themselves, to receive a discount (an undisclosed percentage but greater than 20%) off published rates for services from Company. Individuals eligible for such designation include spouses or domestic partners, family members, and friends of the employee. The employee discount may not be combined with any other promotion and is subject to commercial blackout dates.

Company stated that employees may find bigger discounts on the open market, and that the discount offered under Program is, in most cases, less than that offered to Company's large customers.

The issues considered in the LAFA included:

a. The effect of Program's availability to non-employees who are designated by employees; and

b. Whether IRS should use published rates in computing the employee discount under §132(c)(3) (i.e., as being representative of the price at which the property or services is offered by the employer to customers) for determining whether it exceeds the 20% limitation under §132(c)(1)(B).

The LAFA found that, under the terms of Program, employees can designate up to a certain number of other individuals as eligible for the discount-individuals who do not have to meet the definition of employee under §132(h). Accordingly, the value of any discount given to an individual who is not an employee is taxable as income to the person who designated the non-employee individual. (Regulation §1.61-21(a)(4))

The LAFA noted that, in determining the extent of the discount for purposes of §132(c)(1), the relevant comparison is between the discounted amount paid by employees and the price at which the services are being offered by Company to its customers. (§132(c)(3)) Company argued that the amount of the employee discount should be based upon the discount rates it provides to corporate customers instead of its published rates. However, the LAFA found that Company failed to provide sufficient evidence that the discounted rates are the appropriate benchmark. Among other things, Company did not provide information regarding the number of sales that it made at the discounted rates, so IRS was unable to determine whether such sales comprised 35% of Company's sales. The LAFA determined that IRS should use the published rates until IRS is provided with the requisite information, and since the Program discount rate exceeded 20%, the excess was to be included in the income of the employees as a taxable fringe benefit.

Accordingly, the LAFA held that Company must collect and pay to IRS under §3501(b) employment taxes based on both:

a. The value of discounts given to non-employee individuals through Program on behalf of the employees who designated them; and

b. The value of the excess discount.

Information Letter 2017-0007.

An arrangement where an employer purchased parking spots from a parking vendor, and then allowed employees who wished to use the parking spots to pay the employer for the parking spots using the employees' own after-tax compensation, would not qualify for tax-free treatment.

§132(a)(5) allows employers that provide an employee with a "qualified transportation fringe" to exclude the benefit from the employee's gross income. A qualified transportation fringe includes "qualified parking."

Under §132(f)(5)(C), "qualified parking" is defined as parking an employer provides that is located on or near the employer's business premises. Under Regulation §1.132-9(b), Q&A 4(d), parking is considered be provided by the employer if: (1) it is provided on property that the employer owns or leases; (2) the employer pays for the parking; or (3) the employer reimburses the employee for parking expenses.

Employer paid a parking vendor directly for the parking spots. The employees who wished to use the secure parking had to agree, in writing, to reimburse the employer by having the monthly parking fee deducted from their paycheck in the month prior to using the parking. The employees could not get a refund of the withheld funds if they did not use the parking.

The cost of the parking was less than the federal statutory limit ($255 a month in 2016 and 2017). The employees were not given the option of choosing between taxable cash compensation and parking. As a result, Employer did not exclude the cost of the parking from the taxable wages of those employees who have elected to use the parking. Instead, Employer simply deducted the cost of the parking from the employees' after-tax wages.

The employees who have elected to use the parking spots have asked IRS whether the amounts deducted from their wages for parking could be excluded from their income and wages as a qualified parking benefit.

In the Information Letter, IRS advises that an arrangement such as Employer's-where the employer purchases parking spots from a parking vendor and then in turn permits employees who wish to use the parking spots to pay the employer for the parking spots using the employees' own after-tax compensation-does not meet the requirements to be considered qualified parking under §132(f)(5)(C).

IRS noted that if Employer had instead decided to reimburse employees for qualified parking expenses, it could do so either by providing the reimbursements in addition to the employee's regular wages or, alternatively, by providing the reimbursements in place of pay. Reimbursements provided in place of pay are called "compensation reduction arrangements." Under compensation reduction arrangements, the employer allows the employees to elect to reduce their taxable compensation in order to receive tax-free reimbursements for parking expenses that the employees have actually incurred.

Information Letter 2016-0081.

Post-retirement payments that an individual received from his company were subject to self-employment tax because the payments resulted from his 34 years of services on behalf of the company.

A taxpayer's self-employment income is subject to self-employment tax. Self-employment income is generally defined as the net earnings from self-employment derived by an individual from any trade or business carried on by such individual, less allowable deductions, plus certain partnership adjustments. (§1402(a), §1402(b))

Under *Newberry*, (1981) 76 TC 441, to be self-employment income, there "must be a nexus between the income received and a trade or business that is, or was, actually carried on." Additionally, the income "must arise from some actual (whether present, past, or future) income-producing activity of the taxpayer before such income becomes subject to...self-employment taxes."

Under §1402(k), net earnings from self-employment does not include any amount received during the tax year from an insurance company on account of services performed by an individual as an insurance salesman for the company if: (1) the amount is received after termination of the individual's agreement to perform services for the company; (2) the individual performs no services for the company after the agreement ends and before the close of the tax year; (3) the payments are conditioned on the salesman's agreeing not to compete with the company for at least one year following termination of the agreement; and (4) the amount of the payment depends primarily on: (a) policies sold by, or credited to the account of, the individual during the last year of the agreement, and/or (b) the extent to which the policies remain in force for some period after the agreement ends.

In a case of first impression for the Circuit, the Eleventh Circuit, affirming the Tax Court, recently held that payments made under post-retirement deferred compensation plans to a company's former national sales director were subject to self-employment tax under §1401. The taxpayer, a long-serving National Sales Director for Mary Kay, began receiving payments under two plans once she retired, one based a percentage of the sales commissions of the sales network that she had developed and the other based on a percentage of commissions from her foreign sales units. The court concluded these payments were subject to self-employment tax because they resulted from her association with Mary Kay. *(Peterson v. Commissioner,* (CA 11 7/8/2016) 117 AFTR 2d 2016-1815)

In the Information Letter, IRS determined that the post-retirement payments that the taxpayer received from his company were subject to self-employment tax. IRS reasoned that under §1402(b), payments are subject to self-employment tax if they are net earnings from self-employment-i.e., gross income derived by an individual from any trade or business carried on by such individual. Under Newberry, the self-employment tax applies when there is a nexus between the income received and a trade or business that is, or was, actually carried on. Here, the payments to the taxpayer were as a result of his 34 years of services on behalf of the company. IRS also relied on Peterson, where the Court found that payments similar to those received by the taxpayer here were subject to self-employment tax.

IRS also noted that, while the taxpayer correctly observed that §1402(k) provides that certain payments are not subject to self-employment tax, this exclusion is a narrow one. It applies only to certain payments made to former insurance company salesmen (and even then, only if those payments meet a series of specific requirements). §1402(k) did not apply to the payments that the taxpayer received from his company.

Notice 2017-48, 2017-39 IRB; IR 2017-143

Employees will not be taxed when they forgo vacation, sick, or personal leave in exchange for employer contributions of amounts to charitable organizations providing relief to Hurricane Harvey and Tropical Storm Harvey (collectively, Hurricane Harvey) victims, and employers may deduct the amounts as business expenses.

Some employers have set up or may be considering setting up programs where employees can donate their vacation, sick or personal leave in exchange for the employer making cash payments to qualified tax-exempt organizations that provide relief for the victims of Hurricane Harvey. In the past, under similar circumstances, IRS has provided guidance for such donations. See, for example, Notice 2012-69, 2012-51 IRB 712, which provided guidance with respect to leave-based donation programs to aid victims of Hurricane Sandy, and, more recently, Notice 2016-69, 2016-48 IRB 832, which provided guidance with respect to leave-based donation programs to aid victims of Hurricane Matthew.

In Notice 2017-48, IRS has announced that it will not assert that cash payments an employer makes to §170(c) organizations in exchange for vacation, sick, or personal leave that its employees elect to forgo, constitute gross income or wages of the employees, if the payments are: (1) made to the §170(c) organizations for the relief of Hurricane Harvey victims; and (2) paid to the §170(c) organizations before Jan. 1, 2019. Nor will giving employees the choice to participate cause them to be considered in constructive receipt of income. However, employees who participate in a leave-sharing donation program will not be allowed to claim a charitable contribution deduction for the value of forgone leave excluded from compensation and wages.

As for employers, IRS will not assert that payments made under a leave-sharing donation program are deductible as charitable contributions under §170, rather than deductible as business expenses under §162.

Observation: Thus, the employer will be able to deduct the payments without being subject to the various charitable contribution limits that apply under §170.

Treatment of Form W-2. Amounts representing leave-sharing donations need not be included in Box 1 (wages, tips, or other compensation), Box 3 (Social Security wages, if applicable), or Box 5 (Medicare wages and tips) of Form W-2.

Observation: In other words, these amounts also will be free of income- and payroll-tax withholding.

Observation: Participation in these programs can help both employees who itemize and those who do not. For example, a non-itemizer who forgoes $2,000 worth of leave will get the equivalent of a $2,000 deduction that would not be available if he or she took the leave and contributed $2,000 in cash. And, the lower adjusted gross income (AGI) from participating in the program may make it possible for the employee to achieve a greater tax benefit from any of the numerous deductions and credits that are reduced as AGI increases. For example, participation may yield a higher deduction for a contribution to a traditional IRA. Itemizers can also benefit from the lower AGI. Both itemizers and non-itemizers can save Social Security taxes on the amount forgone. On the downside, participation could result in smaller retirement plan contributions depending on how compensation is defined under the employer's retirement plan.

Notice 2017-40, 2017-32 IRB.

IRS has extended through 2021 earlier guidance on the tax consequences of programs that involve payments made to or on behalf of financially distressed homeowners, including a safe harbor method for computing a homeowner's deduction for payments made on a home mortgage. The Notice also extends penalty relief related to information reporting for mortgage servicers and state housing finance agencies.

Payments made under legislatively provided social benefit programs for the promotion of general welfare are not includible in a recipient's gross income. (Revenue Ruling 74-205, 1974-1 CB 20, Revenue Ruling 98-19, 1998-1 CB 840) Two types of such programs are: (1) programs designed by State Housing Finance Agencies (State HFAs) with funds allocated from the Housing Finance Agency Innovation Fund for the Hardest-Hit Housing Markets (HFA Hardest Hit Fund), and (2) HUD's Emergency Homeowners' Loan Program (EHLP) and any existing state program receiving funding from the EHLP (the substantially similar state programs, or SSSPs).

Under §6041, every person engaged in a trade or business (including state governments and their agencies) must: (1) file an information return for each calendar year with respect to each person to whom, in the course of its trade or business for that year, it pays fixed and determinable income aggregating $600 or more; and (2) furnish a copy of the information return to that person.

And under §6050H, every person engaged in a trade or business (including state governments and their agencies) must: (1) file an information return for each calendar year with respect to each individual from whom, in the course of its trade business, it receives interest aggregating $600 or more on a mortgage; and (2) furnish a copy of the information return to that individual.

§6721 and §6722 impose penalties for failure to comply with the information return rules.

Notice 2011-14, 2011-11 IRB 544, provided guidance on the federal tax consequences of, and information reporting obligations associated with, payments made to or on behalf of financially distressed homeowners under the above-described State HFAs and HUD's EHLP (and SSSPs receiving funding from it). In general, such payments are not included in the recipient's gross income under the above "general welfare exclusion" rules.

Notice 2011-14 also provided:

a. A safe harbor which, for tax years 2010 through 2012, allowed an eligible homeowner to deduct on his federal income tax return an amount equal to the sum of all payments he actually made during that year to the mortgage servicer, HUD, or the State HFA on the home mortgage, but not in excess of the sum of the amounts shown on Form 1098, Mortgage Interest Statement, in box 1 (mortgage interest received), box 4 (mortgage insurance premiums, for years 2010 and 2011 only), and box 5 (real property taxes);

b. Information reporting relief, which provided that payments to or on behalf of a homeowner made under the State HFA, the EHLP, and the SSSP are not subject to §6041. Also, interest received from a governmental unit (or agency or instrumentality) is not reportable under §6050H as interest received on a mortgage; and

c. Penalty relief, which provided that IRS would not assert penalties under §6721 and §6722 against:

    1. A mortgage servicer that reports on Forms 1098 (Mortgage Interest Statement) payments received under a State Program, the EHLP, or an SSSP during calendar years 2011 or 2012 if the servicer notifies homeowners that the amounts reported on the Forms 1098 are overstated because they include government subsidy payments; or

    2. Any State HFA for failing to file and furnish correct Forms 1098, in either 2011 or 2012, if the State HFA provides each homeowner and IRS with a statement setting forth (a) the homeowner's name and taxpayer identification number (TIN), and (b) the amount of payments that the State HFA made to a mortgage servicer under the State Program or the SSSP during that year.

In Revenue Procedure 2011-55, 2011-47 IRB 793, IRS supplemented Notice 2011-14 and specified where the State HFAs and HUD should send these statements, applicable filing deadlines, and also advised them of Form 1098-MA (Mortgage Assistance Payments), which they could opt to use as a statement that satisfied the above requirement.

In Notice 2013-7, 2013-6 IRB 477, IRS extended the above relief through 2015. It amplified Notice 2011-14 by: extending the safe harbor method for computing a homeowner's deduction for payments made on a home mortgage; extending the relief for mortgage servicers and State HFAs from penalties relating to information reporting; and advising HUD that it may rely on Notice 2011-14 to report, to homeowners and IRS, payments made to mortgage servicers. In addition, Revenue Procedure 2011-55 amplified Notice 2011-14 by revising the safe harbor method for computing a homeowner's deduction in light of the fact that §163(h)(3)(E), under which taxpayers can deduct mortgage insurance premiums as qualified residence interest, was reinstated and extended by the 2012 American Taxpayer Relief Act (P.L. 112-240) to apply to premiums paid or accrued before 2014.

In Notice 2015-77, 2015-47 IRB 676, IRS further extended the safe harbor method for computing a homeowner's deduction for payments made on a home mortgage and the relief for mortgage servicers and State HFAs from penalties relating to information reporting through 2017. Notice 2015-77 also amplified Revenue Procedure 2011-55 by extending its scope and effective date through calendar year 2017 for the HFA Hardest Hit Fund.

Notice 2017-40 extends through tax year 2021 the safe harbor method for computing a homeowner's deduction for payments made on a home mortgage and the relief for mortgage servicers and State HFAs from penalties relating to information reporting. It also amplifies Revenue Procedure 2011-55 by extending its scope and effective date through calendar year 2021 for the HFA Hardest Hit Fund.

Under Notice 2017-40, for tax years 2010 through 2021, an eligible homeowner (i.e., one who meets the requirements of §163 and §164, and participates in a State program in which the program payments could be used to pay interest on the home mortgage) may deduct the lesser of:

1. The sum of all payments on the home mortgage that the homeowner actually makes during a tax year to the mortgage servicer or the State HFA; or

2. The sum of amounts shown on Form 1098, Mortgage Interest Statement, for mortgage interest received, real property taxes, and mortgage insurance premiums (if deductible for the tax year under §163(h)(3)(E)).

Observation: The deduction for mortgage insurance premiums as qualified residence interest under §163(h)(3)(E) expired at the end of 2016, and it is presently uncertain as to whether and when this provision will be further extended, made permanent, or left expired.

The §6721 and §6722 penalty relief is also extended through 2021. IRS will not assert these penalties against a mortgage servicer that reports, on Forms 1098, payments received under a State Program during calendar years 2011 through 2021 if the servicer notifies homeowners that the amounts reported on the Form 1098 are overstated because they include government subsidy payments.

IRS will not assert penalties under §6721 and §6722 against any State HFA for failing to file and furnish Forms 1098 for calendar years 2011 through 2021 if the State HFA provides each homeowner and IRS a statement setting forth (1) the homeowner's name and taxpayer identification number (TIN), and (2) the amount of payments the State HFA made to the mortgage servicer under the State Program during that year (separately stating the amount the State HFA paid and the amount the homeowner paid). Except as provided in Revenue Procedure 2011-55 regarding use of Form 1098-MA, the statement the State HFA provides to IRS must be a single statement that separately lists the names, TINs, and relevant payment amounts for each homeowner.
Notice 2017-40 also provides that, for calendar years 2011 through 2021, State HFAs may, at their option, use Form 1098-MA in accordance with Revenue Procedure 2011-55 to provide the information described above instead of filing a single statement for the calendar year.

Notice 2017-3, 2017-2 IRB.

2017 maximum fair market values (FMVs) for employer-provided autos, trucks and vans, the personal use of which can be valued for fringe benefit purposes at the mileage allowance rate (53.5¢ per mile for 2017). It also has released the 2017 maximum fleet-average vehicle FMVs for autos, trucks and vans for purposes of the annual lease value (ALV) fringe benefit valuation method.

An employer must treat an employee's personal use of an employer-provided auto as fringe benefit income and value it using one of several methods. One of the permitted methods allows an employer to value personal use at the mileage allowance rate (53.5¢ per mile for 2017). However, this method may be used only if the auto's FMV does not exceed $12,800, as adjusted for inflation under §280F(d)(7).

The inflation-adjusted figures for vehicles first made available to employees for personal use in 2017 are $15,900 for autos (same as for 2016) and $17,800 for trucks and vans-i.e., passenger autos built on a truck chassis, including minivans and sport-utility vehicles (SUVs) built on a truck chassis-(up from $17,700 for 2016). (Notice 2017-3)

Under the table value method, the fringe benefit value of an employee's personal use of a company-provided auto is found in a table in Regulation §1.61-21(d)(2)(iii). The employer determines the FMV of the auto, finds the dollar range in the table which corresponds to the FMV, and multiplies the ALV shown in the table for that FMV by the ratio of the employee's annual personal mileage for the auto to total annual mileage (employment-connected business driving plus personal driving). (Regulation §1.132-5(b)(1)(i); Regulation §31.3501(a)-1T, Q&A 7) An employer with a fleet of 20 or more autos may determine the ALV of each auto in the fleet as if its FMV were equal to the "fleet-average value." This "fleet-average value" is the average of the FMVs of the autos in the fleet. The fleet-average valuation rule cannot be used to compute the annual lease value of any auto whose FMV exceeds an annually adjusted inflation-indexed figure. (Regulation §1.61-21(d)(5)(v)(D))

Under Notice 2017-3, the fleet-average valuation rule cannot be used to determine the ALV of any vehicle if its FMV on the date it is first made available in 2017 for employee personal use exceeds $21,100 for a passenger auto (down from $21,200 for 2016) or $23,300 for a truck or van (up from $23,100 for 2016). If all other applicable requirements are met, an employer with a fleet of 20 or more vehicles consisting of passenger autos as well as trucks and vans may use the fleet-average valuation rule as long as none exceeds its respective maximum allowable value.

Observation: The official 2017 figures for fleet-average ALV purposes are identical to the figures calculated and reported by Thomson Reuters Checkpoint in November 2016.

Notice 2016-79, 2016-52 IRB; IR 2016-169.

Optional mileage allowance for owned or leased autos (including vans, pickups or panel trucks) will decrease by 0.5¢ to 53.5¢ per mile for business travel after 2016. This rate can also be used by employers to provide tax-free reimbursements to employees who supply their own autos for business use, under an accountable plan, and to value personal use of certain low-cost employer-provided vehicles. And, the rate for using a car to get medical care or in connection with a move that qualifies for the moving expense deduction will decrease by 2¢ to 17¢ per mile.

The mileage allowance deduction replaces separate deductions for lease payments (or depreciation if the car is purchased), maintenance, repairs, tires, gas, oil, insurance and license and registration fees. The taxpayer may, however, still claim separate deductions for parking fees and tolls connected to business driving. (Revenue Procedure 2010-51, 2010-51 IRB 883)

Employers that require employees to supply their own autos may reimburse them at a rate that does not exceed the business mileage allowance for employment-connected business mileage, whether the autos are owned or leased. (Revenue Procedure 2010-51, §9.01) The reimbursement is treated as a tax-free accountable-plan reimbursement if the employee substantiates the time, place, business purpose, and mileage of each trip. Additionally, an employee's personal use of lower-priced company autos may be valued at the optional mileage allowance if the conditions specified in Regulation §1.61-21(e)(1) are met.

A separate rate applies for using a car to get medical care or in connection with a move that qualifies for the moving expense deduction. (Revenue Procedure 2010-51) The mileage rate for driving an auto for charitable use (14¢ per mile) is a statutory rate that's not adjusted for inflation. (§170(i))

IRS generally adjusts the standard mileage rate annually, based on a yearly study of the fixed and variable costs of operating an auto. However, IRS has made mid-year adjustments in certain years when necessary to better reflect the real cost of operating an auto in light of rapidly rising gas prices.

Observation: The advantages to using the standard mileage rate include: (1) Mileage rate users need not keep a record of actual expenses or retain receipts that would otherwise be required. A record of the time, place, business purpose and number of miles traveled suffices. (2) If an auto's business expenses are deducted via the mileage rate, it is not subject to the §280F dollar caps or the special rules that apply if qualified business use does not exceed 50% of total use. (3) The mileage rate method may yield bigger deductions than the actual expense method for a thrifty, high-mileage-per-gallon model.

Notice 2016-79 provides that the standard mileage rate for transportation or travel expenses is 53.5¢ per mile for all miles of business use (business standard mileage rate). The standard mileage rate is 17¢ per mile for use of an auto (1) for medical care described in §213; or (2) as part of a move for which the expenses are deductible under §217. The standard mileage rate is 14¢ per mile for use of an auto in rendering gratuitous services to a charitable organization under §170. (Notice 2016-79, §3)

As Notice 2016-79 notes, taxpayers using the standard mileage rates must comply with Revenue Procedure 2010-51. Accordingly, the standard mileage rate may not be used for a purchased auto if:

a. It was previously depreciated using a method other than straight-line for its estimated useful life;
b. A §179 expensing deduction was claimed for the auto;
c. The taxpayer has claimed the additional first-year depreciation allowance for the auto;
d. The taxpayer depreciated it using MACRS under §168; or
e. The taxpayer is a rural mail carrier who receive qualified reimbursements. (Revenue Procedure 2010-51)

A taxpayer who uses the mileage allowance method for an auto he owns may switch in a later year to deducting the business-connected portion of actual expenses, so long as he depreciates it from that point on using straight-line depreciation over the auto's remaining life. The depreciation deductions would still be subject to the §280F dollar caps. (Revenue Procedure 2010-51, §4.05(3))

Observation: One of the disadvantages to using the standard mileage rate is that the mileage rate method may produce a smaller deduction than would be obtained by claiming actual business-connected operating expenses plus depreciation (or lease payments). Also, use of the mileage rate method prevents the taxpayer from claiming regular MACRS deductions (subject to the luxury auto dollar caps) for the auto in later years.

For 2017, Notice 2016-79, §4 provides that the depreciation component of the mileage rate for autos used by the taxpayer for business purposes is 25¢ per mile. (It was 24¢ per mile for 2016 and 2015; 22¢ per mile for 2014; and 23¢ per mile for 2013.) The depreciation component reduces the basis of the auto for gain or loss purposes. (Revenue Procedure 2010-51, §4.04)

A taxpayer may use the mileage allowance method for a leased auto only if he uses that method (or a fixed and variable rate (FAVR) allowance method) for the entire lease period. (Revenue Procedure 2010-51, §4.05(2)) Employers may use a FAVR allowance method to reimburse employees who supply their own cars for business (whether the cars are leased or owned). For 2017, the standard auto cost used to compute the FAVR allowance cannot exceed $27,900 (down from $28,000 for 2016). For trucks or vans, the 2017 standard auto cost used to compute the FAVR allowance cannot exceed $31,300 (up from $31,000 for 2016). (Notice 2016-79, §5)

The revised standard mileage rates in Notice 2016-79 (53.5¢ for business; 17¢ for medical or moving) apply to deductible transportation expenses paid or incurred for business, medical, or moving expense purposes on or after January 1, 2017, and to mileage allowances or reimbursements that are paid to an employee or charitable volunteer (1) on or after January 1, 2017, and (2) for transportation expenses paid or incurred by the employee or charitable volunteer on or after January 1, 2017. (Notice 2016-79, §6)

Notice 2016-72, 2016-50 IRB.

Rules under which distressed homeowners who participate in the Federal Housing Finance Agency's (FHFA's) Principal Reduction Modification Program (PRMP) or the Home Affordable Modification Program (HAMP) can meet §108(a)(1)(E)(ii) 's "discharged... subject to an arrangement that is entered into and evidenced in writing before January 1, 2017" rule for debt forgiveness income exclusion.

Under §61, except as otherwise provided in subtitle A, gross income means all income from whatever source derived, including income from discharge of indebtedness. (§61(a)(12)) §108(a)(1)(E), as extended by the Protecting Americans from Tax Hikes Act of 2015 (PATH Act, P.L. 114-113, 12/18/2015), provides that gross income does not include any amount that (but for §108(a)) would be includible in gross income by reason of the discharge (in whole or in part) of a taxpayer's indebtedness if the indebtedness discharged is "qualified principal residence indebtedness" that is discharged (a) before January 1, 2017, (§108(a)(1)(E)(i)) or (b) subject to an arrangement that is entered into and evidenced in writing before January 1, 2017. (§108(a)(1)(E)(ii))

Under §108(h)(2) and §163(h)(3)(B), qualified principal residence indebtedness is any indebtedness that is incurred by a borrower to buy, build, or substantially improve the borrower's principal residence and is secured by that residence. Qualified principal residence indebtedness also includes a loan secured by the borrower's principal residence that refinances qualified principal residence indebtedness, but only to the extent of the amount of the refinanced indebtedness. (§108(h)(2), §163(h)(3)(B)(i)) The maximum amount of discharged indebtedness that a borrower may exclude from gross income under the qualified principal residence indebtedness exclusion is $2 million ($1 million for a married individual filing a separate return). (§108(h)(2))

To help distressed borrower-homeowners lower their monthly mortgage payments, FHFA directed the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) to implement the PRMP, which offers mortgage loan modifications to certain seriously delinquent, underwater borrower-homeowners who are still struggling in the aftermath of the financial crisis, to help them avoid foreclosure and stay in their homes. The PRMP is a targeted, one-time offering for borrower-homeowners whose loans are owned or guaranteed by Fannie Mae or Freddie Mac and who meet specific eligibility criteria.

For a borrower-homeowner to take advantage of the PRMP, the mortgage loan servicer must solicit the borrower-homeowner's participation by sending the borrower-homeowner a notice of PRMP eligibility in conjunction with a written TPP or, for a borrower-homeowner in an active TPP, a separate notice of PRMP eligibility in a written opt-out letter. The TPP and the PRMP notice set out Trial Period and PRMP Conditions that the borrower-homeowner must satisfy for there to be a permanent modification of the mortgage loan.

In the case of an active TPP, the notice in the written opt-out letter outlines the terms and conditions of the principal reduction feature of the loan modification. If the Trial Period and PRMP Conditions are satisfied within a required time frame, then the borrower-homeowner is offered a permanent modification of the terms of the mortgage loan. If the borrower-homeowner executes and returns the loan modification agreement, the mortgage loan is thereby modified. The modification includes monthly mortgage payments that are lower than or equal to those under the old mortgage loan and, generally, a principal reduction.

HAMP, currently available through the end of 2016, offers a program similar to PRMP to help distressed borrower-homeowners lower their monthly mortgage payments. To help financially distressed homeowners lower their monthly mortgage payments, the Department of Housing and Urban Development (HUD) established HAMP. Under the HAMP, the principal of the borrower's mortgage may be reduced over three years by a predetermined amount called the "PRA Forbearance Amount" if the borrower satisfies certain conditions during a trial period. Depending on the borrower's trial period payment history, compliance with HAMP and servicer guidelines, and his satisfaction of other conditions, the borrower will be offered a permanent modification of the terms of the mortgage loan, including monthly mortgage payments that are lower than those under the old mortgage loan. Until the effective date of a permanent modification, the terms of the existing mortgage loan continue to apply. Revenue Procedure 2013-16, IRB 488, explains the federal tax consequences of principal reduction of a mortgage loan under the HAMP Principal Reduction Alternative.

Notice 2016-72 provides that qualified principal residence indebtedness is discharged "subject to an arrangement that is entered into and evidenced in writing before January 1, 2017" within the meaning of §108(a)(1)(E)(ii) if:

1. Before that date, a mortgage servicer sends a borrower-homeowner under the FHFA's PRMP a notice in conjunction with a written TPP or, for a borrower-homeowner in an active TPP, a separate notice in a written opt-out letter outlining the terms and conditions of the permanent mortgage loan modification following completion of the active TPP;

2. The borrower-homeowner satisfies all of the Trial Period and PRMP Conditions; and

3. The borrower-homeowner and servicer enter into a permanent modification of the mortgage loan on or after January 1, 2017.

Notice 2016-72 provides that a similar conclusion applies to a TPP under HAMP.

IRS reasoned that the addition of §108(a)(1)(E)(ii) by the PATH Act was designed to ensure that discharges of qualified principal residence indebtedness in these situations qualified for exclusion from income.

IRS noted that in the PATH Act Congress extended the relief under §108(a)(1)(E) to arrangements entered into and evidenced in writing before January 1, 2017. Congress added §108(a)(1)(E)(ii) to protect a borrower-homeowner who is in the process of obtaining a permanent modification of the mortgage loan during 2016, although the permanent modification of the mortgage loan resulting in discharge of indebtedness would not occur until after 2016. For example, a borrower-homeowner who is in the process of obtaining a modified mortgage loan under the PRMP during 2016, because the borrower-homeowner is either in an active TPP or the mortgage loan servicer sends the borrower-homeowner a notice in conjunction with a TPP, might not complete the modification process until after 2016.

IRS also noted that a discharge of indebtedness that did not qualify for the qualified principal residence indebtedness exclusion in §108(a)(1)(E) may qualify for another exclusion, such as the insolvency exclusion under §108(a)(1)(B) or the deductible debt exclusion under §108(e)(2). For example, a cash basis homeowner generally would exclude from income under §108(e)(2) the discharge of any accrued but unpaid interest on the mortgage for his principal residence to the extent the interest would have been deductible if paid. (Johnson, TC Memo 1999-162)

IR 2017-109.

IRS announced that it is now accepting renewal applications for the Individual Taxpayer Identification Numbers (ITINs) set to expire at the end of 2017. IRS urged taxpayers affected by changes to the ITIN program to submit their renewal applications as soon as possible to avoid an anticipated rush.

Any individual filing a U.S. tax return is required to state his or her taxpayer identification number on that return. Generally, a taxpayer identification number is the individual's Social Security number (SSN). However, in the case of individuals who are not eligible to be issued an SSN, but who still have a tax filing obligation, IRS issues ITINs for use in connection with the individual's tax filing requirements. (Regulation §301.6109-1(d)(3)(i))

The *Protecting Americans from Tax Hikes* (PATH) Act (P.L. 114-113), enacted late in 2015, made a number of changes to the ITIN program, including providing that ITINs that have not been used on a federal tax return at least once in the last three consecutive years will expire December 31, 2017, and ITINs with middle digits 70, 71, 72 or 80 will also expire at the end of the year. (§6109(i)(3)(B)(ii)) Affected taxpayers who expect to file a tax return in 2018 must submit a renewal application.

ITINs with middle digits of 78 and 79 already expired last year. Taxpayers with these ITIN numbers can renew at any time.

In the News Release, IRS reminded taxpayers that they can now begin submitting ITIN renewal applications. Taxpayers whose ITIN is expiring and who need to file a tax return in 2018 must submit a renewal application. While Federal returns that are submitted in 2018 with an expired ITIN will be processed, exemptions and/or certain tax credits will be disallowed. Taxpayers will receive a notice in the mail advising them of the change to their tax return and their need to renew their ITIN. Once the ITIN is renewed, any applicable exemptions and credits will be restored and any refunds will be issued.

In the News Release, IRS also advised that an ITIN with the middle digits 70, 71, 72, or 80 (For example: 9NN-70-NNNN; NNN-71-NNNN; 9NN-72-NNNN; 9NN-80-NNNN) need to be renewed even if the taxpayer has used it in the last three years. IRS will begin sending the CP-48 Notice (You must renew your Individual Taxpayer Identification Number (ITIN) to file your U.S. tax return) later this summer to affected taxpayers. The CP-48 Notice explains the steps to take to renew the ITIN if it will be included on a U.S. tax return filed in 2018. Taxpayers who receive the notice after taking action to renew their ITIN do not need to take further action unless another family member is affected.

Taxpayers with an ITIN with middle digits 70, 71, 72 or 80 have the option to renew ITINs for their entire family at the same time. Those who have received a renewal letter from IRS can choose to renew the family's ITINs together even if family members have an ITIN with middle digits other than 70, 71, 72 or 80. Family members include the tax filer, spouse and any dependents claimed on the tax return.

To renew an ITIN, a taxpayer must complete a Form W-7 (Application for IRS Individual Taxpayer Identification Number) and submit all required documentation. Taxpayers submitting a Form W-7 to renew their ITIN are not required to attach a federal tax return. However, taxpayers must still note a reason for needing an ITIN on the Form W-7. IRS began accepting ITIN renewals on June 21.

The application package can be submitted in three ways:

1. By mail, along with original identification documents or copies certified by the agency that issued them, to the address listed on the Form W-7 instructions. IRS will review the identification documents and return them within 60 days;

2. By working with a Certified Acceptance Agent (CAA), who is authorized by IRS to help taxpayers apply for an ITIN. CAAs review all documentation for a taxpayer and certify that the application is correct before submitting it to IRS for processing. CAAs can also certify passports and birth certificates for dependents, saving taxpayers from having to mail original documents to IRS; and

3. By making an appointment at a designated IRS Taxpayer Assistance Center in lieu of mailing original identification documents to IRS.

IRS advised that several common errors can slow down and hold up some ITIN renewal applications. The mistakes generally center on missing information and/or insufficient supporting documentation. IRS urges any applicant to check over their form carefully before sending it to IRS.

IRS also reminded taxpayers that it no longer accepts passports that do not have a date of entry into the U.S. as a stand-alone identification document for dependents from a country other than Canada or Mexico, or dependents of U.S. military personnel overseas. The dependent's passport must have a date of entry stamp, otherwise the following additional documents to prove U.S. residency are required: U.S. medical records for dependents under age 6; U.S. school records for dependents under age 18; and U.S. school records (if a student), rental statements, bank statements or utility bills listing the applicant's name and U.S. address, if over age 18.

To increase the availability of ITIN services nationwide, particularly in communities with high ITIN usage, IRS is actively recruiting CAAs, and applications are now accepted year-round.

IR 2017-86, Fact Sheet 2017-7, 04/19/2017.

IRS has announced that it has created a special new page on its website (https://www.irs.gov) to help taxpayers determine if a person visiting their home or place of business claiming to be from the IRS is legitimate or an imposter. Most of this information is also contained in a contemporaneously released Fact Sheet.

Types of IRS contact. With continuing phone scams and in-person scams rampant, IRS wants taxpayers to understand how and when IRS contacts taxpayers and to help them determine whether a contact is truly from an IRS employee. While IRS initiates most contacts through regular mail delivered by the U.S. Postal Service, IRS reminds taxpayers that IRS employees do make official, sometimes unannounced, visits to taxpayers as part of their routine casework. Visits typically fall into three categories:

a. Collection. In special circumstances-such as when a taxpayer has an overdue tax bill or to secure a delinquent tax return or a delinquent employment tax payment-IRS revenue officers will sometimes make unannounced visits to a taxpayer's home or place of business to discuss taxes owed or tax returns due. They will not demand that a taxpayer make an immediate payment to a source other than the U.S. Treasury.

b. Audits. IRS revenue agents will sometimes visit a taxpayer who is being audited. IRS employees conducting audits may call taxpayers to set up appointments, but not without having first notified them by mail. After mailing an initial appointment letter, an auditor may call to confirm and discuss items pertaining to the scheduled audit.

c. Criminal investigation. IRS criminal investigators may visit a taxpayer's home or place of business unannounced while conducting an investigation. However, these are federal law enforcement agents, and they will not demand any sort of payment. Criminal investigators also carry law enforcement credentials, including a badge.

Verification. Taxpayers should keep in mind the reasons these visits occur and understand how to verify if it is IRS knocking at their door. If an IRS representative visits a taxpayer, he or she will always provide two forms of official credentials called a pocket commission and a HSPD-12 card. The HSPD-12 is a government-wide standard for secure and reliable forms of identification for Federal employees and contractors. Taxpayers have the right to see these credentials.

IRS notes that a legitimate IRS representative will not:

a. Demand that the taxpayer use a specific payment method, such as a prepaid debit card, gift card or wire transfer. IRS will not ask a taxpayer for a debit or credit card numbers over the phone.

b. Demand that the taxpayer pay taxes without the opportunity to question or appeal the amount they say the taxpayer owes. Generally, IRS will first mail the taxpayer a bill if he or she owes any taxes. The taxpayer should also be advised of his or her rights as a taxpayer.

c. Threaten to bring in local police, immigration officers, or other law-enforcement to have the taxpayer arrested for not paying. IRS also cannot revoke a taxpayer's driver's license, business licenses, or immigration status. Threats like these are common tactics that scam artists use to trick victims into buying into their schemes.

IRS notes that it can assign certain cases to private debt collectors but only after giving the taxpayer and his or her representative, if one is appointed, written notice. Private collection agencies will not ask a taxpayer for payment on a prepaid debit card or gift card. Taxpayers can learn more about the IRS payment options on https://www.irs.gov/payments. Payment by check should be payable to the U.S. Treasury and sent directly to IRS, not the private collection agency. For more about private debt collection agencies, see https://www.irs.gov/businesses/small-businesses-self-employed/private-debt-collection.

III. CORPORATIONS, PARTNERSHIPS, LLCs AND BUSINESS RELATED.

Amazon.com, Inc. & Subsidiaries, (2017) 148 TC No. 8.

Important transfer pricing opinion where Tax Court rejected the IRS's preferred approach to pricing cost-sharing buy-in payments as inconsistent with the arm's length standard, employing reasoning that has implications for related-party transfers of intangible property in general. The opinion represents the latest in a series of court decisions rejecting the IRS's interpretation and application of the arm's length standard, especially with respect to transfers of intangible property between related parties.

The Amazon court held that the IRS's "all-in" aggregated income method was arbitrary, capricious, and unreasonable as applied to price a buy-in payment under the pre-2009 version of the cost sharing regulations. The court rejected the IRS's method because it effectively assumed a perpetual life for the transferred intangibles and inappropriately swept in elements of value that were not actually transferred in the buy-in transaction and that were not compensable "intangibles" to begin with.

The Amazon opinion also addressed issues relating to the determination of costs to be included in the cost sharing pool. The IRS sought to include in the cost sharing pool 100 percent of the costs from certain Amazon cost centers, but the court upheld as reasonable Amazon's allocation of a portion of these costs to other activities not covered by the cost sharing arrangement.

Finally, the court made no adjustment to Amazon's intangible development cost (IDC) pool for stock-based compensation, finding that Amazon's "clawback" provision had not yet been triggered in light of the Tax Court's decision in *Altera Corporation,* 145 TC No. 3 (July 27, 2015). In Altera, the Tax Court invalidated Regulation §1.482-7(d)(2) and the requirement that stock-based compensation must be shared among cost sharing participants (the IRS has since appealed the Tax Court's decision to the Court of Appeals for the Ninth Circuit).

The Tax Court's opinion in Amazon is important for a number of reasons. The valuation of buy-in payments under the pre-2009 cost sharing regulations has been a source of continuing controversy between taxpayers and the IRS. By rejecting the IRS's preferred approach and accepting a valuation based on transactional comparables and a fact-based analysis establishing limited useful lives for the transferred intangibles, the Amazon court provides critical guidance on the fundamental principles to be applied in determining arm's length pricing for transfers of intangibles.

The cost sharing regulations at issue in Amazon have since been substantially overhauled, with the current regulations being issued in temporary form in 2009 and finalized in 2011. The current cost sharing regulations reflect many of the precise theories and arguments that the IRS put forth in Amazon. As a result, the rejection of the IRS's theories in Amazon may have implications for issues arising under the 2009 and 2011 cost sharing regulations as well as the pre-2009 cost sharing regulations applicable to Amazon's facts.

As recent transfer pricing cases clearly demonstrate, courts will not hesitate to reject IRS positions where the court finds the IRS's position fundamentally inconsistent with the arm's length standard or unsupported by arm's length evidence. Further, a court may not be inclined to defer to a regulation if it concludes the IRS is attempting to bootstrap its position in litigation using the regulatory process.

Under §482, in the case of any transfer or license of intangible property between controlled entities, IRS may allocate income, deductions, credits, or allowances between the entities to prevent the evasion of taxes or to clearly reflect income. Consideration for intangible property transferred in a controlled transaction must be commensurate with the income attributable to the intangible. The standard to be applied is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer, which is determined under the method that, given the facts and circumstances of the case, provides the most reliable measure of an arm's length result.

Under the regulations in effect in 2005 when the taxpayer entered into its cost sharing arrangement(CSA), when one participant makes pre-existing intangible property available for purposes of research under a CSA, that party is deemed to have transferred an interest in such property to the other participant. This requires the other participant to make a "buy-in payment" to the transferor. (Regulation §1.482-7(g)(1)) The buy-in payment must only reflect the pre-existing intangibles. (Regulation §1.482-7(g)(2))

In *Veritas Software Corporation ,* (2009) 133 TC 297, the Tax Court held that IRS's determinations were arbitrary, capricious, and unreasonable. according to the Court, IRS did not offer any meaningful explanation for the $825 million decrease in its buy-in valuation, failed to call as a witness the individual who provided the initial $2.5 billion valuation, and relied on the opinion of an expert who himself admitted that a critical factor relating to the calculation of the allocation was incorrect. The Tax Court also held that the CUT method employed by Veritas US, with appropriate adjustments, was the best method to determine the requisite buy-in payment.

On November 3, 1999, Veritas Software (Veritas US) and its subsidiary Veritas Ireland had entered into a CSA, which consisted of a research and development (R&D) agreement and a technology license agreement. On that same date and pursuant to the CSA, Veritas US transferred preexisting intangible property to Veritas Ireland for a $166 million buy-in payment. Veritas US employed the CUT method to calculate the payment, which evaluated whether the amount charged for a controlled transfer of intangible property was arm's length by referencing the amount charged in comparable uncontrolled transactions.

In *Veritas Software,* IRS employed an income-based method to determine that the upfront buy-in payment should have been for $2.5 billion and made an income allocation to Veritas US for that amount in a notice of deficiency issued to Veritas US. Later in the proceeding, IRS reduced the allocation from $2.5 to $1.675 billion. IRS further determined that the requisite buy-in payment had to take into account access to Veritas US's R&D team; access to its marketing team; and its distribution channels, customer lists, trademarks, trade names, brand names, and sales agreements.

Veritas US filed a petition with the Tax Court to redetermine the deficiencies and penalties set out in IRS's deficiency notice, contending that IRS's determinations were arbitrary, capricious, and unreasonable, and that the CUT method was the best method to calculate the requisite buy-in payment.

In 2005, Amazon.com, Inc. and its domestic subsidiaries (collectively, Amazon US) entered into a CSA with Amazon Europe Holding Technologies SCS (AEHT), its Luxembourg subsidiary. Pursuant to the CSA, Amazon US granted AEHT the right to use certain pre-existing intangible assets in Europe. These assets included: (1) the software and other technology required to operate Amazon US's European websites, fulfillment centers, and related business activities; (2) marketing intangibles (including trademarks, tradenames, and domain names relevant to the European business); and (3) customer lists and other information relating to Amazon US's European clientele. This arrangement required AEHT to make a $254.5 million "buy-in payment" to compensate Amazon US for the value of the intangible assets that were to be transferred to AEHT. Thereafter AEHT was required to make annual cost sharing payments to compensate Amazon US for ongoing IDCs, to the extent those IDCs benefited AEHT.

In determining the value of the transferred assets, Amazon US assumed that each group of assets (website technology, marketing intangibles, and customer information) had a 7-year useful life. Applying a discounted cash-flow (DCF) methodology to the expected cash flows from the European business, IRS determined a buy-in payment of $3.6 billion, which it later reduced to $3.468 billion. Amazon US argued that this DCF methodology treated short-lived intangibles as if they had perpetual useful lives with the result that it inflated the buy-in payment by improperly including in it the value of subsequently developed intangible property. Further, IRS's DCF methodology was substantially similar to that rejected by the Tax Court in Veritas Software. Amazon US contended that IRS's determinations were arbitrary, capricious, and unreasonable and that the comparable CUT method was the best method to calculate the requisite buy-in payment.

Amazon US used a multistep allocation system to allocate costs from its various cost centers to IDCs. Amazon US determined that only about half of the costs captured in one important cost center (Technology and Content) should be allocated to IDCs. While accepting Amazon US's allocation method in many respects, IRS determined that 100% of the cost in Technology and Content had to be allocated to IDCs. Amazon US argued that IRS's determination was inconsistent with the regulations.

Two main issues needed to be resolved in this case: (a) the proper amount of AEHT's buy-in obligation with respect to the assets transferred; and (b) the volume of Amazon US's costs properly treated as IDCs (since the larger the volume, the larger the cost sharing payments that AEHT must make).

Relying on Veritas Software, the Tax Court found that IRS's determination with respect to the buy-in payment was arbitrary, capricious, and unreasonable.

Noting the essential similarity between the DCF methodologies employed here and the one discredited in Veritas Software, the Court found that by assuming a perpetual useful life, IRS failed to restrict its valuation to the pre-existing intangible property and improperly included in the buy-in payment the value of subsequently developed intangibles. The Court reasoned that new products and services (such as the Kindle, Amazon Prime, the Fire smartphone, Fire TV, etc., which were in early development as of January 2005), as well as the next generation of Amazon's website platform, would be created thanks to massive projected IDC investments by Amazon in years after 2004. AEHT would have paid, via cost sharing, its ratable share of these future IDCs, and it would thus co-own these subsequently-developed intangibles. Because AEHT would pay for these assets via cost sharing, it was not required to pay for them through the upfront buy-in payment. No buy-in payment was required for subsequently developed intangibles.

The Tax Court concluded that Amazon US's CUT method-with appropriate upward adjustments in numerous respects-was the best method to determine the requisite buy-in payment.

In addition, the Tax Court found that IRS had abused its discretion in determining that 100% of Technology and Content costs constituted IDCs.

Both Amazon US and IRS recognized that Technology and Content included "mixed costs"-that is, costs that contributed to the intangible development area as well as and other areas or other business activities. Technology and Content employees engaged in substantial non-IDC activities, such as helping vendors list their products on Amazon's websites, making minor adjustments to how website content was displayed, and managing third-party digital content that was viewed on or downloaded from Amazon.com; other Technology and Content employees negotiated contracts with vendors and documented routine activities for them; and were responsible for Sarbanes-Oxley compliance. Notwithstanding this, IRS argued that Amazon US could not an allocation methodology until it first established, on a cost-by-cost basis, which particular costs related only partially to intangible development. The Tax Court held that it was not necessary that the parties painstakingly examine each cost in the 200-plus baseline cost centers in order to determine whether a nontrivial portion of the Technology and Content category costs were "mixed." The Court pointed out that IRS's audit team did not require that level of granularity when accepting Amazon US's allocation method with respect to other categories (for example, Marketing and Fulfilment), and the Tax Court could see no logical reason for imposing harsher requirements on Amazon US before allowing it to allocate costs within the Technology and Content category.

The Court determined that Amazon US's cost-allocation method-with certain adjustments-supplied a reasonable basis for allocating costs to IDCs.

BASR Partnership, (Ct Fed Cl 1/31/2017) 119 AFTR 2d ¶ 2017-405.

The Court of Federal Claims has awarded a partnership over $300,000 for attorney fees. In so doing, it rejected a series of arguments by IRS, including that partners and not partnerships can receive such an award and that, where a partnership challenges a final partnership audit adjustment (FPAA), tax liability is not in issue.

A prevailing party may recover reasonable administrative costs and litigation costs incurred in a tax matter brought by or against IRS. (§7430(a)) A party, for this purpose is any party in any proceeding to which §7430(a) applies. (§7430(c)(4)(A))

The prevailing party is the party which has "substantially prevailed with respect to the amount in controversy or has substantially prevailed with respect to the most significant issue or set of issues presented." (§7430(c)(4)(A)) A party is not treated as the prevailing party if IRS establishes that its position was substantially justified. (§7430(c)(4)(B)(i)) These requirements are waived, however, if the final judgment in the court proceeding is equal to or less than the amount of a party's "qualified offer." (§7430(c)(4)(E), §7430(g))

A party may not be considered a prevailing party unless that party meets the net worth requirements of section 2412(d)(2)(B) of the Equal Access to Justice Act (EAJA). (§7430(c)(4)(A)(ii)) Section 2412(d)(2)(B) of the EAJA defines a "party" as: (i) an individual whose net worth did not exceed $2,000,000 at the time the civil action was filed, or (ii) a partnership, "the net worth of which did not exceed $7,000,000 at the time the civil action was filed, and which had not more than 500 employees at the time the civil action was filed." Regulation §301.7430-5(g)(5)(i) also contains this partnership net worth, etc. rule.

§7430(c)(1)(B)(iii) (and the §7430(c)(1) flush language) generally limits the hourly rate for attorney's fees to $125 per hour, plus an adjustment for cost of living, unless the Court determines that a special factor such as the limited availability of qualified attorneys for the proceeding, the difficulty of the issues presented, or the local availability of tax expertise justifies a higher rate. The statutory rate for attorney's fees incurred in 2015 and 2016 was $200 per hour. (See Revenue Procedure 2014-61, 2014-47 IRB 860; Revenue Procedure 2015-53, 2015-44 IRB 615) Under Tax Court Rule 232(e), the taxpayer bears the burden of proving that the amount of costs he claimed is reasonable.

Under the TEFRA unified partnership audit procedures that generally apply to partnership tax years that begin before January 1, 2018, IRS issues an FPAA notifying the partners of any adjustments to the partnership items, and the partners may seek judicial review of the FPAA. (§6223(a)(2), §6226(a), §6226(b))

The taxpayer, BASR, was a partnership. IRS issued an FPAA to BASR. BASR argued that the FPAA was not timely issued and thus was not effective. Both the Court of Federal Claims (see *BASR Partnership by & through Pettinati,* (Ct Fed Cl 2013) 112 AFTR 2d 2013-6313), and the Court of Appeals for the Federal Circuit (see *BASR Partnership,* (CA FC 2015) 116 AFTR 2d 2015-5432), held for BASR in this matter. The courts denied the government's claim to apply §6501(c)'s fraud suspension to regular 3-year assessment period in case involving partnership tax shelter transaction. Although the attorney who promoted the transaction admitted to fraud, §6501 's language and history, particularly when taken in context of overall statutory scheme for fraudulent conduct, showed that §6501(c) suspension could not be triggered by attorney's fraud, but rather was triggered only when taxpayers themselves intended to evade tax, which was found not to be the case here.

In the current case, BASR sought an award under §7430 for its litigation costs.

IRS made numerous arguments to reduce or eliminate BASR's litigation cost award, but the court rejected them all.

Partnerships are "parties." IRS argued that BASR was never a "party" in this case. It looked to TEFRA provisions as support for its argument. A tax matters partner may file a petition for a readjustment of an FPAA with the U.S. Court of Federal Claims. (§6226(a)(3)) §6226(c) provides that the parties may include "each person who was a partner in [the] partnership at any time during [the relevant partnership tax year]." The Tax Court has interpreted §6226(c) as standing for the proposition that "the partners, rather than the partnership entity, are the parties in a TEFRA proceeding." (*Foothill Ranch,* (1998) 110 TC 94) And IRS noted that the rules of the U.S. Court of Federal Claims also provide, in Appendix F, that: "for purposes of this Appendix, the United States, the partner who filed the complaint, the tax matters partner, and each person who satisfies the requirements of §6226(c)...shall be treated as parties to the action."

But the court said that Regulation §301.7430-5(g)(5)(i), which provides the net worth requirement for partnerships, would be superfluous under IRS's interpretation; it therefore rejected IRS's argument. And, it said that its interpretation is consistent with the TEFRA partnership provisions, because TEFRA was enacted to create a single unified procedure for determining the tax treatment of all partnership items at the partnership level, rather than separately at the partner level.

Tax liability is an issue in partnership audit cases. In order that an offer by a taxpayer be a "qualified offer," the offer must, among other things, specify the offered amount of the taxpayer's liability. (§7430(g)(1)(B)) The qualified offer rule, however, does not apply in "any proceeding in which the amount of tax liability is not in issue." (§7430(c)(4)(E)(ii)(II))

Here, IRS argued that tax liability was not "in issue," because, under TEFRA, partnership-level FPAA review proceedings do not determine the tax liability of any partner. Instead, FPAA judicial review proceedings determine the tax treatment of partnership items. See §6226(f). The tax liabilities of individual partners then are determined in subsequent proceedings at the partner level. (§6230(a)(1), §6230(a)(2))

The court rejected IRS's government. It said that, although IRS was correct that the partners' final tax liability is determined at the partner level, it is not correct that tax liability was not "in issue" in this case. The partnership-level FPAA review proceeding conclusively determines the tax treatment of all partnership items, determining each individual partner's tax liability.

FPAAs and the "qualified offer period." To be considered a qualified offer, the taxpayer's offer must be made during the "qualified offer period." (§7430(g)(1)) The "qualified offer period" is defined as the period "beginning on the date on which the first letter of proposed deficiency which allows the taxpayer an opportunity for administrative review in the [IRS] Office of Appeals is sent" and "ending on the date which is 30 days before the date the case is first set for trial." (§7430(g)(2)(A), §7430(g)(2)(B))

IRS made several arguments that an FPAA is not a letter of proposed deficiency; the court rejected all of them. The court noted that Regulation §301.7430-3(c)(3) provides, for purposes of determining reasonable administrative costs under §7430, that an FPAA is equivalent to a notice of deficiency that commences the "qualified offer period." IRS argued that that provision applies to administrative costs but not to litigation costs. The court disagreed with that argument. The court also noted two cases not involving §7430 that held that an FPAA is the functional equivalent of a notice of deficiency. See *Sealy Power, Ltd.,* (CA 5 1995) 75 AFTR 2d 95-1213 and *Clovis I,* (1987) 88 TC 980.

IRS then argued that an FPAA is not a letter of proposed deficiency because an FPAA does not specify any amount of tax due, as required by the §7522. Under §7522, the letter of proposed deficiency, must: "describe the basis for, and identify the amounts (if any) of, the tax due, interest...and assessable penalties included in such notice." (Emphasis added) But the court said that §7522 does not, as IRS argued, require that the first letter of proposed deficiency specify an amount of tax due. Instead, that statute requires that the first letter of proposed deficiency specify the amount of tax due, if any.

IRS also argued that an FPAA is not a letter of proposed deficiency because it is a "notice of a final partnership adjustment" that does not allow the taxpayer "an opportunity for administrative review" before the IRS Office of Appeals. But the court said that regulations provide that a taxpayer still gets the full benefit of the "qualified offer" provisions, even if the taxpayer receives only a "final" notice of deficiency and never receives such notice in proposed form. See Regulation §301.7430-7(e), Example 14 (explaining that a taxpayer will be treated as making a "qualified offer" even if he only receives a final notice of deficiency). Moreover, the issuance of an FPAA does allow for some administrative review; specifically, the case will be returned to the IRS Office of Appeals if partners opt out of court proceedings by settling with IRS. See §6224(c); Revenue Procedure 87-24, 1987-22 IRB 23.

As a result, the court determined that the date of an FPAA is tantamount to the date of a letter of proposed deficiency that commences the qualified offer period.

Taxpayer awarded costs at higher than statutory hourly rate. The court also concluded that BASR could collect attorney fees at higher than the statutory rate.

First the court rejected one of BASR's arguments in this regard. BASR argued that it was unable to locate qualified tax counsel, either locally or nationally, that would undertake representation at a $200 or less per hour rate. The court said that the "limited availability of qualified attorneys" means an actual shortage of qualified attorneys who handle the case rather than an inability to retain qualified counsel willing to take on the representation at the statutory maximum hourly rate.

But, the court accepted BASR's argument that the following factor, contained in Regulation §301.7430-4(b)(3)(iii), justified the higher rate: "the complexity of the particular provision or provisions of law involved in each issue." The court noted that the BASR's case involved the interaction of two separate statutes of limitation contained in the Code, at both the trial and appellate levels. It noted that one of the judges in that case wrote an opinion concurring in judgment but offering a different interpretation of the statutes at issue. In addition, coming to the correct conclusion required the Court of Appeals for the Federal Circuit to examine "the overall statutory scheme of the Code, the case law, and §6501(c)(1) 's historical roots."

IRS also argued that, even if BASR deserved a higher rate for its attorney fees with respect to the statute of limitations case, it did not deserve a higher rate with respect to attorney time for this case, i.e., its case to obtain a litigation cost award. The court disagreed with IRS here as well, noting "I must say I was surprised at the number of arguments that the Government has raised...I've never seen a brief that was this long for a fee argument for the Government."

Chamber of Commerce of the U.S. of America, (DC TX 9/29/2017) 119 AFTR 2d ¶ 2017-5300

A district court has held that one of the 2016 anti-inversion temporary regulations - Regulation §1.7874-8T -is invalid because IRS did not meet the notice and comment requirements that apply when agencies issue regs. The court also determined that the taxpayer, the U.S. Chamber of Commerce (the Chamber), had standing to bring the case, that the Chamber did not violate the Anti-Injunction Act by bringing the case, that the substance of the regulation did not exceed the statutory authority that provided for its issuance, and that the regulation was not "arbitrary and capricious."

In general, if three conditions are met, §7874 either prevents the use of certain tax attributes to reduce the U.S. federal income tax owed on certain income or gain (inversion gain) recognized in transactions intended to remove foreign operations from the U.S. taxing jurisdiction, or treats the new foreign parent corporation as a domestic corporation for all purposes of the Code.

The first two conditions under §7874 are: (1) the foreign acquiring corporation completes, after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation (domestic entity acquisition); (2) after the domestic entity acquisition, at least 60% of the stock (by vote or value) of the foreign acquiring corporation is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation.

Regulation §1.7874-8T (the Rule), promulgated in 2016, identifies stock of foreign acquiring corporations that is to be disregarded in determining the ownership fraction because the stock is attributable to prior domestic-entity acquisitions.

The Rule was issued pursuant to statutory authority in the Code, which provides: "The Secretary shall prescribe such regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations (A) to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and (B) to treat stock as not stock." (§7874(c)(6)) And further, "The Secretary shall provide such regulations as are necessary to carry out this section, including regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section, including the avoidance of such purposes through (1) the use of related persons, pass-through or other noncorporate entities, or other intermediaries, or (2) transactions designed to have persons cease to be (or not become) members of expanded affiliated groups or related persons." (§7874(g))

The first question is whether the court has jurisdiction, which includes the issue of standing.

Standing contains three elements: (1) The plaintiff must have suffered an injury in fact-an invasion of a legally protected interest which is (a) concrete and particularized, and (b) actual or imminent, not conjectural or hypothetical; (2) there must be a causal connection between the injury and the conduct complained of-i.e., the injury has to be fairly traceable to the challenged action of the defendant; and (3) it must be likely, as opposed to merely speculative, that the injury will be redressed by a favorable decision. (*Lujan v. Defs. of Wildlife*, (S Ct 1992) 504 U.S. 555)

"The required publication or service of a substantive rule shall be made not less than 30 days before its effective date, except [for]...(2) interpretative rules and statements of policy (5 USC §553(d)) And, a "subsequent statute may not be held to supersede or modify [this notice-and-comment rule]...except to the extent that it does so expressly." (5 USC §559)

The Code strictly limits the circumstances under which a suit to enjoin the assessment or collection of any tax is permitted. Under §7421(a) (the Anti-Injunction Act), no suit for the purpose of restraining the assessment or collection of any tax can be maintained in any court by any person, whether or not that person is the one against whom the tax is assessed, except as otherwise provided.

5 USC §706 provides that, "The reviewing court shall ... hold unlawful and set aside agency action, findings, and conclusions found to be...in excess of statutory jurisdiction, authority, or limitations, or short of statutory right...[or] arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."

The Chamber challenged the Rule on various grounds. IRS first argued that the Chamber did not have standing and then argued against each of the grounds asserted by the Chamber.

The court ruled that the Chamber had standing to bring the case. The Chamber alleged that it had standing based on the fact that Allergen plc (Allergen) was a member of the Chamber. The Chamber asserted that the Rule eliminated tax benefits associated with a proposed merger contemplated by Allergen that was announced in November 2015. At the time the merger was proposed, the corporate composition of Allergen was the product of several acquisitions of U.S. corporations by a foreign corporation over the previous three years. As a result of the previous acquisitions, the entity that would have resulted from the proposed merger would have been categorized as a U.S. corporation due to application of the Rule and thus would have been subject to U.S. federal income tax. Before promulgation of the Rule, the entity would not have been subject to the tax.

The court said that an association has standing to bring suit on behalf of its members when: (a) its members would otherwise have standing to sue in their own right; (b) the interests it seeks to protect are germane to the organization's purpose; and (c) neither the claim asserted nor the relief requested requires the participation of individual members in the lawsuit.

The court concluded that Allergen would have standing to sue. It said that the purpose of the Rule was to make inversions so economically infeasible that companies would elect not to pursue them and that the Rule succeeded in doing exactly that. Allergen did not need to engage in futile negotiations for deals that have been altogether foreclosed or made economically impracticable by the Rule. It was enough that Allergen identified a specific transaction that was thwarted by the Rule and asserted that it would actively pursue other inversions if this court were to set aside the challenged Rule.

In addition, the court concluded that the Chamber had standing because one of its members, Allergen, was a targeted object of the challenged Rule. "When the suit is one challenging the legality of government action" and "the plaintiff is himself an object of the action," there "is ordinarily little question that the action. . . has caused him injury." (Lujan) Chamber provided proof that IRS specifically targeted Allergen.

Court rules that the Rule is invalid due to IRS's failure to meet notice and consent requirements. The court held that the Rule is invalid because IRS did not meet the notice and comment requirements.

The Rule was issued both as a temporary regulation effective immediately and as a proposed regulation subject to notice and comment. IRS argued that it may issue temporary regulations without subjecting them to notice and comment before they become effective if the regulation is simultaneously issued as a proposed regulation subject to notice and comment.

IRS argued that Congress's intent to make a substantive change to the APA is clear in the wording of the statute allowing for temporary regulations, §7805(b) .

The court disagreed. It said that §7805(b) specifically refers to permissible effective dates of regulations and publication of notice in the Federal Register as required by the APA but does not mention an exception for temporary rules. ("[N]o temporary, proposed, or final regulation relating to the internal revenue laws shall apply to any taxable period ending before the earliest of the following dates:...In the case of any final regulation, the date on which any proposed or temporary regulation to which such final regulation relates was filed with the Federal Register..."). The statute puts additional restrictions on when a regulation may become effective; it neither explicitly states nor suggests Congressional intent to allow a regulation to become effective earlier in relation to publication than provided for in the APA.

IRS also argued that legislative history indicates Congress's intent to allow IRS's practice of passing temporary rules effective immediately without a 30-day notice period or opportunity for comment. The court said that it would not disregard explicit directives of the APA in favor of legislative history.

And, the court determined that the Rule does not meet the "interpretive" exception in 5 USC §553(d). For example, the statute authorizing IRS to promulgate the Rule states that the regulations may "provid[e] for...adjustments to the application of this section." (§7874(g)) Permitted regulations under the statute include "regs to treat stock as not stock." (§7874(c)(6)) But, adjustments to application and treating stock as if it were not stock-see Regulation §1.7874-8T(b) -are not mere interpretations of the statute but substantive modifications to the application of the statute.

Observation: Thus, based on the holding in this case, IRS cannot avoid the notice and comment rule with respect to a temporary regulation merely by promulgating it together with a proposed reg. However, the holding does not prevent a temporary regulation that is an interpretive regulation from avoiding the notice and comment rule.

The court also held that the Chamber did not violate the Anti-Injunction Act by bringing the case, that the substance of the Rule did not exceed the statutory authority that provided for its issuance, and that the Rule was not "arbitrary and capricious."

As to the Anti-Injunction Act, the court, citing the Supreme Court in *Direct Mktg. Ass'n v. Brohl, (S Ct 2015) 135 S Ct 1124,* said that assessment and collection of taxes do not include all activities that may improve the government's ability to assess and collect taxes.

Here, the court said, the Chamber did not seek to restrain assessment or collection of a tax against or from them or one of their members. Rather, the Chamber challenged the validity of the Rule so that a reasoned decision could be made about whether to engage in a potential future transaction that would subject its member to taxation under the Rule. Further, the Rule is not a tax, but a regulation determining who is subject to taxation under provisions of the Code. Enforcement of the Rule precedes any assessment or collection of taxes. Although the Rule may improve the government's ability to assess and collect taxes, enforcement of the Rule does not involve assessment or collection of a tax.

As to the statutory authority issue, the court said that §7874(c)(6) and §7874(g) use terms granting broad authority to IRS. The statute does not limit the broad authority by identifying regulations that would not be appropriate or providing boundaries to IRS's authority under the statute. Based on the broad authority granted by Congress, the court concluded the Rule does not exceed IRS's statutory jurisdiction. The Rule directs that certain stock be disregarded in calculations made under the statute, which falls into the statute's allowance that regulations may "treat stock as not stock."

As to the "arbitrary and capricious" rule, the court said that, generally, agency action is arbitrary and capricious if the agency has relied on factors which Congress did not intend it to consider, entirely failed to consider an important aspect of the issue before it, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise. The standard of review is highly deferential to the action of the agency.

The court said that it reviewed the full analysis by which IRS determined that the Rule is necessary to achieve the goals of the Code. It concluded that IRS did not rely on factors that Congress did not intend for it to consider or fail to consider an important aspect of the issue before it.

Chemtech Royalty Associates v. U.S., L.P. v. U.S., (CA 5 5/17/2016) 117 AFTR 2d 2016-1750, cert denied 1/9/2017.

The Supreme Court has declined to review a decision of the Court of Appeals for the Fifth Circuit that upheld the imposition of penalties for negligence and substantial understatement with regard to tax shelter partnership transactions effected by a multinational chemical company. The Fifth Circuit found that the purported partnership should be disregarded as a sham and rejected the taxpayer's argument that it had substantial authority for treating the partnership as valid.

Taxpayers are subject to a 20% accuracy-related penalty for an underpayment of tax attributable to negligence or a substantial understatement of income. Negligence includes any failure to make a reasonable attempt to comply with the tax laws. A substantial understatement occurs when the amount by which a corporate taxpayer understates its tax obligation exceeds the lesser of $10 million or 10% of the tax actually owed. (§6662(a), §6662(c), §6662(d)(1)(B))

A taxpayer may reduce or eliminate the substantial-understatement penalty by showing that it had "substantial authority" for its position. (Regulation §1.6662-3(b)(3)) The amount of the substantial understatement used to compute the penalty does not include any item for which there was substantial supporting authority. (§6662(d)(2)(B)(i)) For substantial authority to exist, the weight of the authorities supporting the treatment must be substantial in relation to the weight of authorities supporting contrary treatment. (Regulation §1.6662-4(d)(3)(i))

Under current law, this reduction does not apply for items attributable to the tax shelters. (§6662(d)(2)(C)(i)) However, for the years at issue in this case, the substantial authority exception did apply to tax shelters where the taxpayer reasonably believed that the tax treatment of the item by the taxpayer was more likely than not the proper treatment. (Former §6662(d)(2)(C)(i)(II)) A tax shelter included, among other things, a partnership or an investment plan if a significant purpose of such was the avoidance or evasion of Federal income tax. (Former §6662(d)(2)(C)(iii))

The sham-partnership doctrine is a judicial doctrine under which the form of a partnership can be disregarded if the partners do not intend to carry on a joint business enterprise. The Supreme Court explained in *Culbertson,* (S Ct 1949) 31 AFTR 1391 that whether the partnership is respected is a question of fact-i.e., whether the so-called partners intended to "join together for the purpose of carrying on business and sharing in the profits or losses of both"). In making this determination, courts look at the overall facts and circumstances, which include among other things the agreement and the relationship between the parties.

Dow Chemical (Dow) engaged in two complicated series of transactions, Chemtech I and Chemtech II, in the early 1990s, that involved partnerships that generated over $1 billion in tax deductions:

1. Chemtech I was a "Special Limited Investment Partnerships" (SLIPs) transaction. Dow established the Chemtech partnership with its principal place of business in Switzerland, contributed (via a

subsidiary) 73 patents that were very valued at almost $867 million but had a low or zero tax basis, then entered into a licensing agreement under which Dow was obligated to make royalty payments for its continued use of the patents. Five foreign banks also invested in the Chemtech partnership.

The operation of the Chemtech partnership was such that money flowed in a circle, from Dow to the Chemtech partnership (in the form of deductible royalties) and largely back to Dow in the form of a loan-essentially giving the deductions to Dow and allocating most of the income to the foreign investors. The banks were to be paid a fixed annual return on their investment.

Changes in U.S. tax law forced Dow to terminate the Chemtech partnership at the end of 1997.

2. Chemtech II. Once Dow realized it would have to terminate the Chemtech I transaction, it began planning for Chemtech II, which involved the contribution by Dow (through a subsidiary) of a portion of a chemical plant to Chemtech II, a newly formed partnership, and Dow's agreement to lease back the chemical plant.

Following a series of related transactions, Chemtech II ultimately made a §754 election, which essentially allowed it to "strip" basis from certain stock and apply it to Chemtech II's basis in the plant, increasing the $27 million basis by $363 million. This provided Chemtech II with artificially large depreciation deductions.

Similar to Chemtech I, the cash generally flowed in a circle, with Dow making rental payments to Chemtech II, the bulk of which were ultimately loaned back to it.

Chemtech I and Chemtech II generated over $1 billion in tax deductions for Dow. IRS challenged these deductions and asserted accuracy-related penalties.

The district court determined that the partnerships should be disregarded for tax purposes on three grounds: (1) the partnerships were shams; (2) the transactions lacked economic substance; and (3) the banks' interests in Chemtech I were debt, not equity (i.e., the foreign banks were not true partners). The court also found that a 20% penalty for substantial understatement applied, but concluded that substantial-valuation and gross-valuation penalties were foreclosed under existing case law. The district court's decision was rendered before the Supreme Court, in *U.S. v. Woods,* (S Ct 12/3/2013) 112 AFTR 2d 2013-6974, held that the §6662(e) valuation misstatement penalty could be imposed where the underlying transaction lacked economic substance.

The Fifth Circuit found that the district court did not clearly err in holding that Dow lacked the intent to share the profits and losses with the foreign banks, and thus affirmed the sham-partnership holding. However, the Court vacated and remanded the penalties for negligence and substantial understatement in light of the Supreme Court's Woods decision and directed the district court to consider the extent to which imposing those penalties remains consistent with this opinion.

On remand, the district court readopted the factual findings and conclusions of law from its original opinion on the issues of negligence and substantial-understatement penalties, and amended its initial judgment. It held that the gross-valuation misstatement penalty applied to Chemtech II and that the substantial-understatement and negligence penalties vacated in the first appeal applied to both Chemtech I (tax years 1997 through mid-1998) and Chemtech II (tax years mid-1998 through 2006). Because penalties under §6662 do not stack, the result of the district court's decision was to hold applicable a 20% penalty for tax years 1997 to mid-1998 (at issue in this case) and a 40% penalty for tax years mid-1998 to 2006.

Dow again appealed, arguing that the Fifth Circuit's mandate on remand from the first appeal required the district court to justify any tax penalty solely on the ground that Chemtech I was a sham partnership. Further, it argued that such could not be so justified because Dow had a reasonable basis and substantial authority for its contrary position that Chemtech I was a valid partnership.

The Fifth Circuit affirmed the applicability of the negligence and substantial-understatement penalties imposed on Dow. It concluded that the district court did not err in failing to justify these penalties specifically on the basis of the Fifth Circuit's sham-partnership holding, rejecting Dow's characterization of its purpose in remanding. Notably, the Fifth Circuit emphasized that it did not remand out of disapproval with the district court's original grounds for applying the penalties, but rather simply in light of the intervening Woods case.

The Fifth Circuit also concluded that Dow lacked substantial authority for its position that Chemtech I was a valid partnership and thus could not avoid penalties on that basis. It found the cases cited by Dow to be materially distinguishable from the facts at hand, and even if they were not, it stated that these cases would not constitute substantial authority for Dow's position.

On January 9, 2017, the Supreme Court refused to review the Fifth Circuit's decision. Accordingly, that decision is now final.

Crestek, Inc. & Subsidiaries, (2017) 149 TC No. 5.

The Tax Court rejected the taxpayer's argument that IRS may only make adjustments under the U.S. property rules that applies to controlled foreign corporations (CFCs) in the year in which a CFC first acquires the U.S. property.

In general, U.S. shareholders of a foreign corporation are not subject to U.S. taxation on the income of the foreign corporation until an actual dividend is remitted by the foreign corporation to the U.S. shareholders. However, different rules apply to U.S. shareholders of a CFC.

A CFC is defined in §957(a) as any foreign corporation if more than 50% of the total combined voting power of all classes of stock entitled to vote, or more than 50% of the total value of the stock of the corporation, is owned directly, indirectly, or constructively by U.S. shareholders on any day during the tax year of the foreign corporation. A U.S. shareholder, in turn, is any U.S. person who owns, directly, indirectly, or constructively 10% of more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation. (§951(b))

§951(a)(1) requires that a U.S. shareholder owning CFC stock on the last day of the CFC's tax year include in gross income (among other things) "the amount determined under §956 with respect to such shareholder for such year." Under §956(a), the amount determined under §956 with respect to a U.S. shareholder is the lesser of:

1. The excess (if any) of (A) such shareholder's pro rata share of the average of the amounts of U.S. property held (directly or indirectly) by the controlled foreign corporation as of the close of each quarter of such tax year, over (B) the amount of earnings and profits described in §959(c)(1)(A) with respect to such shareholder; or

2. Such shareholder's pro rata share of the applicable earnings of such controlled foreign corporation.

U.S. property includes (among other things) "an obligation of a U.S. person." (§956(c)(1)(C)) For purposes of §956(a), a CFC "shall, under regulations prescribed by the Secretary, be considered as holding an obligation of a U.S. person if such...CFC is a pledgor or guarantor of such obligation."

(§956(d)) Regulation §1.956-2(c)(1) generally provides that any obligation of a U.S. person "with respect to which a...CFC is a pledgor or guarantor" is considered U.S. property held by the CFC.

§956(c)(2)(C) provides that U.S. property does not include: any obligation of a U.S. person arising in connection with the sale or processing of property if the amount of such obligation outstanding at no time during the tax year exceeds the amount which would be ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the U.S. person, had the sale or processing transaction been made between unrelated persons.

The taxpayer, Crestek, was a domestic corporation that was a U.S. shareholder of several CFCs. It also had several U.S. subsidiaries, including CGI and Ultrasonic. The years under IRS audit were fiscal year (FY) 2008 and FY 2009.

CGI borrowed money from the Bank of Islam, a Malaysian bank. CUM, one of Crestek's Malaysian CFCs, provided a guarantee to the bank. In addition, CGI also pledged shares of Crestek's stock as collateral for the bank loan.

Before mid-2005, CUM sold completed products to Ultrasonic, for which Ultrasonic incurred payment obligations in the form of trade receivables. CUM ceased manufacturing operations in mid-2005. The trade receivable balance owed by Ultrasonic to CUM remained constant at $7.92 million from mid-2005 through the end of FY 2009.

The Tax Court rejected the taxpayer's argument that IRS may only make adjustments under §956 in the year in which a CFC first acquires the U.S. property.

The Court said that Congress provided that the §956 inclusion "for any tax year" is to be determined by measuring the average amount of U.S. property held by a CFC "as of the close of each quarter of such tax year." (§956(a)(1)(A)) The statute does not require that the inclusion be made for the first year in which the CFC acquires its investment or that the inclusion be made for any particular year. To the contrary, the statute defines the inclusion for any particular year by reference to "the amounts of U.S. property held (directly or indirectly) by the controlled foreign corporation" during that year. (§956(a)(1)(A)) Thus, where a CFC holds an item of U.S. property for multiple years, §956(a) permits an inclusion in income for any one of those years.

The only relevant limitation is that a §956 inclusion cannot be made more than once for any particular investment by a CFC in U.S. property. Congress accomplished this limitation by providing that any §956 inclusion must be reduced by previously taxed income (PTI) under §959(c)(1)(A).

The Court also rejected the taxpayer's argument that, even if a §956(a) inclusion is required, the Court "must redetermine [its] income for previous years to correctly account for current earnings and profits." Crestek cited §6214 for the proposition that the Court, in redetermining a deficiency for a particular year, "shall consider such facts with relation to the taxes for other years...as may be necessary correctly to redetermine the amount of such deficiency."

The Court said that this argument was misguided. Crestek's own E&P-that is, the E&P of the U.S. parent corporation-was wholly irrelevant in determining the proper amount of a §956 inclusion attributable to investments in U.S. property by CFCs. The entities whose tax attributes are relevant to this determination are the CFCs, not Crestek.

With respect to CFCs, two sets of tax attributes are potentially relevant: their "applicable earnings" and their "previously taxed earnings." (§956(a)(2), §959(c)(1)(A))

The Court rejected Crestek's argument that CUM's loan guarantee had little value and thus should not be considered for purposes of §956(d).

Crestek first noted that CGI had originally pledged 1,500 shares of Crestek's stock as collateral for the Bank of Islam loan. That being so, Crestek asserted that CUM's guaranty was "a meaningless gesture." According to Crestek, CUM's guaranty furnished merely a secondary form of collateral that provided no incremental security for the Bank of Islam.

The Court first noted that it had difficulty seeing the relevance of this argument. §956(d) provides that a CFC is to be considered as holding an obligation of a U.S. person if the CFC "is a pledgor or guarantor of such obligation." Crestek conceded that CUM was a "guarantor." That is the end of the inquiry. Neither §956(d) nor the regulations interpreting it inquire into the relative importance that the creditor attaches to the guarantee.

Besides, as a Malaysian bank, the Bank of Islam may have regarded CGI's pledge of stock in a closely held U.S. company as collateral of questionable value. The Bank of Islam demanded a guaranty from a Malaysian company with Malaysian assets, and CUM duly provided that guarantee.

Alternatively, Crestek asserted that CUM's guaranty was worthless because "other liabilities encumbering CUM's assets exceeded the fair market value of these assets at the time CUM guaranteed the debenture." In contending that CUM was functionally insolvent, Crestek supplied no balance sheets, income statements, or other documentation concerning CUM's financial position at any point in time.

The Tax Court also said that, in any event, it was not clear that CUM's precise financial condition was even relevant in determining whether its guaranty gave rise to an investment in U.S. property. Regulation §1.956-2(c)(1) provides, with an exception not relevant here, that any obligation of a U.S. person with respect to which a CFC is a pledgor or guarantor "shall be considered...U.S. property" held by the CFC. Neither the regulations nor the examples illustrating them make any reference to the likelihood that the CFC will be called upon (or be able) to make good on its guarantee.

The Court also held that the §956(c)(2)(C) did not apply to the CUM receivable from Ultrasonic.

Because CUM had ceased all manufacturing operations by mid-2005, the receivable was a legacy of a business activity that CUM had terminated years previously. While it was an obligation that originally arose "in connection with the sale or processing of property," by FY 2008 it was simply an open account owed to CUM by its U.S. affiliates. Having lost any connection to ongoing commercial transactions, the receivable was not "ordinary and necessary" because CUM and Ultrasonics were no longer engaged in a trade or business with each other.

To qualify for the §956(c)(2)(C) exception, a taxpayer must establish that the amount of the obligation does not exceed the amount that would be "ordinary and necessary to carry on the trade or business" of both parties to the transaction, if the sales or processing transaction had "been made between unrelated persons." In commercial sales transactions between unrelated persons, vendors expect to be paid relatively promptly. The receivable on CUM's books had been outstanding for at least three years and bore no interest. By no stretch of the imagination could this be described as "ordinary" in a sales transaction between unrelated parties. And since there were no ongoing commercial transactions between CUM and its U.S. affiliates, Crestek could not show that any portion of this receivable was "necessary" to facilitate the sale or processing of any property.

Duquesne Light Holdings, Inc. & Subsidiaries V. Commissioner, (CA 3 6/29/2017) 120 AFTR 2d ¶ 2017-5005.

The majority opinion of the Court of Appeals for the Third Circuit, affirming the Tax Court, has concluded that when losses were recognized on the transfer of a parent corporation's subsidiary's stock, and the two corporations filed a consolidated return, the losses claimed on the later sale of the subsidiary's assets had to be disallowed because they duplicated the same economic loss.

In *Charles Ilfeld Co.,* (Sup Ct 1934) 13 AFTR 881, the Supreme Court held that the parent of a group of companies that filed consolidated returns was not entitled to deduct certain losses that had arisen in connection with the dissolution of two of its subsidiaries because the taxpayer had deducted those same losses as operating losses of the subsidiaries in tax years before the one at issue. The Court said that permitting the deduction would allow the taxpayer to use the subsidiaries' losses twice. In the absence of a provision of the Code definitely requiring it, the Court would not assume that such a result so opposed to precedent and equality of treatment was intended.

Thus, under the Ilfeld doctrine, the courts have said that if a deduction represents the same economic loss to the taxpayer as it has already taken a deduction for, and the taxpayer could not point to a specific provision demonstrating Congress's intent to allow the double deductions, then the deduction had to be disallowed.

Starting in the early 1990s, Former Regulation §1.1502-20 prevented, among other things, double deductions when the parent's loss on its sale of stock occurred before the subsidiary recognized its loss. In July 2001, this regulation was invalidated as beyond IRS's power to issue because it addressed a problem not specifically attributable to the filing of consolidated returns. As a result, there was no regulation expressly preventing a double deduction when the parent's stock loss occurred before the subsidiary's asset loss.

However, Former §1.1502-32 prohibited double deductions where the transactions were structured in such a way that the losses occur in reverse order, i.e., the subsidiary's loss was recognized before the parent's loss. In March of 2002, IRS issued Former Regulation §1.337(d)-2T, which applied to stock losses occurring on or after March 7, 2002; while this regulation did not disallow a stock loss that reflected built-in asset losses of a subsidiary member, it did inform taxpayers that IRS believed that a consolidated group should not be able to benefit more than once from one economic loss. In October of 2002, IRS issued Notice 2002-18, 2002-1 CB 644, in which IRS published as guidance a draft of a new regulation barring double deductions. This regulation, Former Regulation §1.1502-35T, was issued in final form applicable retroactively to stock sales occurring on or after March 7, 2002.

Duquesne Light Holdings, Inc. (Duquesne) was the common parent of a consolidated group of corporations (Duquesne group) that filed a consolidated return for all relevant years. Duquesne, by and through its subsidiaries, was in the business of distributing electrical energy to customers throughout certain regions of Pennsylvania. AquaSource, Inc. (AquaSource), an indirect, wholly owned subsidiary of Duquesne and a member of the Duquesne group, was organized for the purpose of acquiring small and mid-size water, wastewater, and water services companies.

On December 31, 2001, Duquesne transferred to Lehman Brothers Holdings, Inc. (Lehman) 50,000 shares of AquaSource stock that it owned (2001 stock transfer) in exchange for $4 million that was payable via certain services which Lehman had already provided or was to provide. Duquesne claimed a capital loss on that transfer of AquaSource stock, which it calculated under §1001 as equal to the excess of its claimed adjusted basis in that stock over the claimed amount realized. Under §165, Duquesne deducted that capital loss ($199,114,494) on the consolidated return that it filed for the Duquesne consolidated return group for the 2001 tax year (2001 stock loss).

On March 18, 2002, Duquesne filed Form 1139, Corporate Application for Tentative Refund, in which it carried back from the 2001 tax year $161,640,702 ($135,267,183 of which was attributable to the 2001 stock loss) to the 2000 tax year.

In 2002, AquaSource sold three of its direct and two of its indirect subsidiaries. Under §165, Duquesne deducted claimed capital losses of $59,584,738 (2002 asset losses) with respect to these sales on the consolidated return that it filed for the Duquesne consolidated return group for the 2002 tax year.

On December 23, 2003, Duquesne filed Form 1139, on which it carried back from the 2002 tax year $63,349,715 of long-term capital losses ($59,584,738 of which was attributable to the 2002 asset losses) to the 2000 tax year.

In 2003, AquaSource sold all of its remaining assets to unrelated third parties. Under §165, Duquesne deducted a claimed capital loss totaling $192,835,360 with respect to those sales on the consolidated return that it filed for the Duquesne consolidated return group for the 2003 tax year (2003 asset losses).

On April 23, 2004, Duquesne filed Form 1139, on which it carried back from the 2003 tax year $184,874,430 of long-term capital losses to the 2000 tax year. On December 23, 2004, Duquesne filed a second Form 1139 on which it carried back from the 2003 tax year $16,531,429 of long-term capital losses to the 2000 tax year. Thus, a total of $201,405,859 of long-term capital losses ($192,835,360 of which was attributable to the 2003 asset losses) were carried back from the 2003 tax year to the 2000 tax year.

On January 27, 2010, IRS issued a notice of deficiency to Duquesne for the 2000 and 2005 tax years. IRS determined a $36,996,999 deficiency for the 2000 tax year.

Alternatively, IRS claimed that if loss recognition in connection with the 2001 transfer of AquaSource stock to Lehman was allowed, losses claimed in connection with the sale of AquaSource assets (asset losses) in 2002 and 2003 were disallowed, as those losses duplicate the economic loss claimed in connection with the 2001 transfer of AquaSource stock. Consequently, losses claimed in 2002 and 2003 in the amounts of $48,682,648 and $150,431,846, respectively, and carried back to the year 2000, were disallowed

The Tax Court held that Duquesne was not entitled to deductions for the 2002 and 2003 tax years for: (1) any of the $59,584,738 in 2002 asset losses; and (2) $139,529,756 of the $192,835,360 in 2003 asset losses. Thus, the Court disallowed $199,114,494 of deductions. (*Duquesne Light Holdings, Inc. & Subsidiaries,* TC Memo 2013-216)

The Tax Court agreed with IRS that there was no genuine dispute that the decrease in the value of the assets of a corporation and the decrease in value of the stock of the corporation represented the same economic decline in value. The 2001 stock loss for which Duquesne claimed a deduction for the 2001 tax year was attributable to Duquesne's claimed sale on December 31, 2001 of certain AquaSource stock that Duquesne owned. The 2002 and the 2003 asset losses for which Duquesne claimed deductions for the 2002 and 2003 tax years were attributable to AquaSource's sales in 2002 of certain assets and its sale in 2003 of all of its remaining assets.

The Tax Court also concluded that there was no specific Code provision at work demonstrating Congress's intent to allow the double deductions. The Court found that §165, which was involved in Duquesne's situation, was a "general allowance" provision that failed to demonstrate an intent to allow a duplicate deduction.

The majority opinion of the Third Circuit found that the Tax Court properly relied on the Ilfeld doctrine to disallow approximately $199 million of the 2002-2003 losses, rejecting Duquesne contention that the Court erred because: (1) the factual record was inadequate to support summary judgment; (2) the Ilfeld doctrine did not support disallowing the losses; and (3) IRS's claims were at least partially barred by the statute of limitations.

The Third Circuit found that IRS demonstrated the absence of a genuine dispute of material fact and that IRS could have met its burden merely by pointing to the absence of evidence supporting Duquesne's position that the losses were not duplicative.

IRS's evidence regarding the size and timing of the losses showed that Duquesne claimed losses were significantly greater than its net investment in AquaSource. Aggregating the 2001 loss and the 2002-2003 losses, IRS determined the Duquesne group deducted far more in aggregate capital losses than its net investment in AquaSource, the difference being $281 million. Because Duquesne had possession of the relevant documents, the Third Circuit presumed that it would have demonstrated that the losses came from different sources if, in fact, they came from different sources.

IRS also met its burden of showing the amount of duplicative losses. As the aggregate excess of deducted losses over net investment implies a double deduction, IRS compared the amount of excess to each deduction. That excess was greater than the deduction claimed for the 2001 stock loss ($199 million), and thus IRS concluded that at least the amount of the 2001 stock loss was deducted twice. Duquesne cited no case in which greater proof was required, nor did it present any evidence that the $199 million figure was inaccurate.

For consolidated taxpayers, the Ilfeld doctrine requires that a statute and/or regulation specifically authorize a double deduction for an underlying economic loss. The Third Circuit rejected Duquesne's argument that a specific authorization for duplication of loss could be found in §165(a) and §165(f): §165(a) provides the general rule for a deduction (singular) of a loss, and §165(f) provides for a deduction for the losses from sales or exchanges of capital assets, subject to limitations irrelevant to the issue of a double deduction for the same economic loss.

Similarly, the Court found that while Duquesne complied with, which required a parent to adjust its basis in line with the subsidiary's earnings and profits, there was nothing in this regulation-either alone or in conjunction with §165 -that permitted a double deduction with anything approaching the specificity that was required to overcome the application of the Ilfeld doctrine. Nor did the Court find any such authorization for a double deduction in Regulation §1.337(d)-2T, rejecting Duquesne's argument that the double negative in that regulation created the inference that any stock losses not reflecting a built-in gain, including duplicative losses, were deductible.

The Third Circuit also rejected Duquesne's claim that IRS was time-barred from ordering repayment of at least some of its tentative refunds resulting from the carryback of the 2002 and 2003 losses to tax year 2000. The Court found that in this case, Duquesne agreed to extend the statute of limitations for tax year 2000. After Duquesne carried back losses from 2003 to 2000 and received a tentative refund, the statute of limitations for tax year 2000 was extended until at least 2006 under §6501(k) (which deals with the assessment periods for tax years for which a quick tentative carryback refund has been granted). It was undisputed that, before that period lapsed, Duquesne agreed to extend the statute of limitations and IRS timely served Duquesne with a notice of deficiency based on losses carried back to 2000. Though Duquesne contended that §6501(k) somehow required that tax year 2002 be within the statute of limitations as well, the Court saw nothing in the subsection's text to disturb well-settled law on the effect of a taxpayer's agreement with IRS. As 2000 was open by agreement with respect to the 2003 losses and the 2002 losses were carried back to 2000 as well, IRS was not time-barred from demanding repayment of the refunds resulting from any losses carried back to 2000.

In a dissenting opinion, Judge Hardiman found that Ilfeld did not bar any double deduction here. Ilfeld yields to a law that can fairly be read to authorize a double deduction. The dissent concluded that Regulation §1.337(d)-2T can fairly be read to authorize a double deduction. The majority did not dispute that Duquesne's returns complied with the applicable regulations: §1.1502-32 (basis calculation) and §1.337(d)-2T (loss allowance). By complying with §1.337(d)-2T, Duquesne's deductions did not violate the principles of Ilfeld.

Eaton Corporation and Subs, TC Memo 2017-147.

The Tax Court, which previously held that it had jurisdiction to review IRS's cancellation of advance pricing agreements (APAs) that it had entered into with Eaton Corporation, has now held that IRS abused its discretion in canceling the agreements.

An APA is an agreement between IRS and a taxpayer setting forth, in advance of controlled transactions, the best transfer pricing method within the meaning of §482 and its regulations. (Revenue Procedure 2004-40) Congress enacted §482 to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes on those transactions. (§482; Regulation §1.482-1(a)(1)) IRS developed the APA program to resolve highly factual transfer pricing issues in a principled, cooperative manner. A taxpayer voluntarily participates in the APA program in exchange for IRS limiting its discretion under §482 to make transfer pricing adjustments. The APA program is intended to supplement traditional administrative, judicial and treaty mechanisms. (Announcement 2012-13, 2012-16 IRB 805; Revenue Procedure 2006-9; Revenue Procedure 2004-40)

Eaton Corporation is an industrial manufacturer that licensed technology to its Puerto Rican and Dominican Republic subsidiaries to manufacture breaker products, including circuit breakers, switches and pushbutton controls, which it then purchased from them. Eaton and IRS entered into two APAs covering 2001 through 2005 (APA I), and 2006 through 2010 (APA II). In the APAs, IRS and Eaton agreed on the best method for determining arm's-length prices under §482 for the purchase of the breaker products. They also agreed that the terms of Revenue Procedure 96-53, 1996-2 CB 375, and Revenue Procedure 2004-40, 2004-2 CB 50, govern the interpretation, legal effect and administration of the APAs, including the conditions under which IRS may cancel them.

In 2011, IRS canceled the APAs effective at the start of 2005 for APA I, and 2006 for APA II, after it determined that there were "material deficiencies in [Eaton's] APA compliance." IRS issued Eaton a deficiency notice in which it determined to increase Eaton's income under §482 by about $102 million for 2005 and $267 million for 2006. Eaton petitioned the Tax Court, claiming it had complied with the APAs' terms and conditions and had demonstrated that to IRS by disclosing errors in its data to IRS in 2010 and rectifying them.

The Tax Court agreed with IRS in 2013 that the APA cancellations were within the Court's deficiency jurisdiction because they are administrative determinations necessary to decide whether the deficiencies asserted by IRS are correct. The Court rejected Eaton's contention that the APAs were governed by contract law principles, concluding that the APAs were, as agreed to by the parties in the APAs themselves, governed by the applicable revenue procedures. Thus, to overcome the APA cancellations, Eaton needed to show that IRS abused its discretion in canceling them.

To determine whether IRS abused its discretion, citing the governing revenue procedures, the Tax Court focused on whether there were any misrepresentations, mistakes as to a material fact, or failures to state a material fact. After exhaustively considering the extremely complicated facts and technical issues of this case, the Tax Court concluded that IRS abused its discretion by canceling APA I for 2005 and APA II for 2006.

From the time of the initial APA discussions, Eaton had advocated a consistent transfer pricing methodology (TPM). The Court noted that IRS entered into not one, but two APAs, and that IRS could have declined to renew APA I and enter into APA II if it wanted to change the TPMs. APA II provided an opportunity to look at the agreement anew. After completing the APA II negotiations, IRS should have had a clear understanding of Eaton's transactions and should not have entered into APA II if it was concerned that Eaton was omitting or misrepresenting information.

The Court found that Eaton's "inadvertent errors" did not fit the APA-governing revenue procedures' definition of "material." It noted that an APA is a binding agreement that should be canceled only according to the terms of the revenue procedures. It should not be canceled because of a desire to change the underlying methodology to one that would result in a significantly different profit split. For these reasons, the Court held that the cancelation of the APAs was arbitrary and unreasonable.

Ford Motor Company v. U.S., (Ct Fed Cl 5/30/2017) 119 AFTR 2d ¶2017-802.

The Court of Federal Claims has denied a U.S. company's claim for a refund based on §6621(d)'s interest netting provisions, finding that the U.S. company and its foreign sales corporation (FSC), i.e., a tax-favored corporation that was allowed under former law, were not the "same taxpayer." The Court rejected the U.S. Company’s argument to disregard the FSC's corporate form, finding that the taxpayers complied with all FSC requirements, including that the FSC establish itself as a foreign corporation separate and distinct from its parent, and received benefits thereunder.

§6621(a)(1) establishes the interest rate for overpayments, and §6621(a)(2) establishes the interest rate for underpayments. Under §6621(d), to the extent that interest is payable for any period under §6601 (imposing interest on underpayments) and allowable under §6611 (paying interest on overpayments) on equivalent underpayments and overpayments by "the same taxpayer," the net rate of interest under §6621 on the underpayment and overpayment amounts is zero for the overlapping period.

Under prior law, an FSC was a corporation created, organized and maintained in a qualified foreign country or U.S. possession outside the U.S. that was entitled to certain tax benefits, including exemption from U.S. tax on a portion of its earnings. (Former Code Secs. 921 - 927) The FSC provisions were repealed for transactions occurring after September 30, 2000.

On December 28, 1984, Ford, a U.S. corporation, formed Export, "a Netherlands private company with limited liability," and owned all of Export's common stock. Ford formed Export "with the intent that Export would qualify as a FSC" and that Ford would benefit from the associated tax advantages.

Export entered into a sale commission agency agreement with Ford and particular subsidiaries of Ford, where Export would "act as a commission agent FSC" with respect to Ford's and the subsidiaries' export transactions and receive commissions in exchange. In a separate agreement, Ford and its subsidiaries agreed to "participate in and perform" all of the activities that Export was responsible for under the commission agency agreement in exchange for compensation-an arrangement that the court noted was authorized by former §925(c). The commissions and income received by Export were immediately paid to Ford as a dividend, with the exception of the finances necessary to satisfy Export's outstanding obligations. Export ceased its sales commission activities after the FSC provisions were repealed in 2000.

The relevant tax return filings by Ford and Export occurred between the tax years of 1990 and 1998. Ford and Export each filed annual tax returns with separate taxpayer identification numbers. Export underpaid its income taxes every year from 1990 to 1998, with the exception of 1994, while Ford overpaid its income taxes for 1992. Ford paid the underpayments owed by Export, plus interest accruing at the standard underpayment interest rate under §6621(a)(2) and §6621(c), between 1999 and 2005, and the government credited the overpayments due to Ford, plus interest accruing at the standard overpayment interest rate under §6621(a)(1), on approximately June 2, 2008. IRS did not apply any interest netting under §6621(d).

In 2010, Export was involved in a series of transactions which Ford claimed resulted in Export's merger into Ford. Ford filed a claim with IRS for refund and request for abatement to recover $20.4 million, requesting that IRS apply interest netting to its overpayments and Export's underpayments. IRS denied Ford's claim, reasoning that Export and Ford were not the same taxpayer because the 2010 transactions "did not result in [Ford] being both liable...for the tax that [Export] underpaid and entitled to a credit or refund of the tax that [Export] overpaid," and thus "did not result in a merger" of Export and Ford.

Ford filed suit in 2014, seeking to recover $20.4 million, which it alleged represents the additional interest for its 1992 overpayment that it would have received if IRS had applied interest netting to Ford's overpayment and Export's underpayments pursuant to §6621(d). In support, Ford alleged that "Ford and Export are the "same taxpayer" for purposes of §6621(d) because, as a FSC, Export had no economic or operational substance and was a fiction created for tax purposes pursuant to the FSC regime."

The case was stayed pending the resolution of a Federal Circuit appeal involving a similar issue (*Wells Fargo & Co v. U.S.,* (CA Fed Cir 2016) 117 AFTR 2d 2016-2263). The disposition of that case specifically foreclosed Ford's argument that Export's 2003 liquidation or 2010 transactions rendered it and Ford the same taxpayer during 1990 to 1998.

The stay was subsequently lifted in 2016, and in 2017, both Ford and IRS sought summary judgment on the issue of whether Ford and Export are the "same taxpayer" for §6621(d) purposes. In light of Wells Fargo, Ford argued instead that the court should disregard Export's corporate form. Ford asserted that it was the same taxpayer as Export during the pertinent time period because Export was wholly owned by Ford and maintained no business purpose other than providing tax advantages to Ford pursuant to the FSC rules, thus making Export "an extension of Ford" for §6621(d) purposes. The government, however, responded that Ford "chose to establish Export as a separate taxpayer," and that Export's substantive business activities and purpose under the FSC provisions demonstrate that Export's separate corporate form should be respected.

The court, siding with the government, concluded that Export and Ford were not the same taxpayer. It rejected Ford's argument that Export was a "legal fiction," reasoning that Export engaged in business activities, filed its own tax return, and satisfied the FSC requirements by, among other things, retaining an office, maintaining a bank account, and holding board of director meetings. In order for the parties to receive the tax advantages of the FSC regime, Export was required to, and did, establish itself as a foreign corporation separate and distinct from Ford.

The court also found that the fact that Ford formed Export to reduce its tax liability does not change the court's analysis because those tax benefits were specifically authorized by Congress. Ford relied on precedents where a taxpayer used the corporate form to improperly avoid tax liability, rendering the entity a sham. (E.g., *U.S. v. Scherping,* (CA 8 1999) 84 AFTR 2d 99-5546) The court reasoned that Ford's "substance over form" position was misplaced not only because Export maintained economic substance, but also because that doctrine applies to disregard a separate corporate entity where Congress has "evinced an intent to the contrary." (*Clougherty Packing Co. v. Commissioner*, (CA 9 1987) 59 AFTR 2d 87-668) Here, Export complied with the FSC rules expressly provided by Congress to lawfully receive otherwise unavailable tax benefits for Ford. Because Export's conduct fell squarely within the scheme intended by Congress, Export's existence as a valid FSC was not analogous to a "sham" entity organized to undermine congressional intent.

Finally, the court found that the legislative purpose underlying the FSC rules and §6621(d) supported the treatment of Export and Ford as separate entities. The FSC rules were based on an FSC's formation as a substantive foreign corporation, with a separate identity from any parent corporation in the U.S. The court also found that the purpose of §6621(d) was to ensure that the same taxpayer is not obligated to pay interest on equivalent underpayments and overpayments-and that Ford already received tax benefits on the basis that Export was a separate entity under the FSC rules. The court ultimately rejected Ford's attempt to now take the opposite position in order to claim further benefits.

Grecian Magnesite Mining, Industrial & Shipping Co., SA, (2017) 149 TC No. 3.

Foreign corporation's proceeds from the redemption of a U.S. limited liability company that was treated as a partnership for U.S. income tax purposes was not U.S.-source income and was not effectively connected with a U.S. trade or business. Foreign corporation engaged in a trade or business within the U.S. during the tax year is subject to U.S. federal income tax on its taxable income that is effectively connected with the conduct of a trade or business within the U.S. (§882)

Generally, foreign source interest income is not treated as effectively connected with the conduct of a U.S. trade or business. (§864(c)(4)(A))

However, §865(e)(2)(A) provides that where a nonresident maintains an office or other fixed place of business in the U.S., income from any sale of personal property, including inventory, attributable to that office is U.S. source income.

§865(e)(3) provides that, in order to determine whether income from a sale is attributable to a U.S. office or fixed place of business, one must look to "[t]he principles of §864(c)(5) ", which provide rules for applying §864(c)(4)(B) to determine what tax items are "attributable to" a U.S. office. Under §864(c)(5)(B), income, gain, or loss is attributable to a U.S. office only if: (a) the U.S. office is "a material factor in the production of such income", and (b) the U.S. office "regularly carries on activities of the type from which such income, gain, or loss is derived." Regulation §1.864-6 refers to these two elements together as the "material factor" test, explaining "regularly carries on activities of the type", see §864(c)(5)(B), as "realized in the ordinary course". (Because the regulations employ the phrase "in the ordinary course" in their application of the statute, the Tax Court also used "ordinary course" in its analysis in this case as a synonym for "regularly carries on activities of the type."

Revenue Ruling 91-32, 1991-1 CB 107, provides that a foreign partner's disposition of its interest in a partnership engaged in a U.S. business is treated as a disposition of an aggregate interest in the partnership's underlying property for purposes of determining the source and the effectively connected character of the gain or loss. Some of the gain or loss may not be attributable to the active conduct of the U.S. trade or business, i.e., if the partnership also owns property that would produce foreign source income if the partnership were to dispose of it. Thus, the gain or loss is attributable to the U.S. business in the ratio that the foreign partner's distributive share of the partnership's net effectively connected gain or loss bears to the foreign partner's distributive share of the partnership's net gain or loss if the partnership had itself disposed of all its assets at fair market value.

In 2001, *Grecian Magnesite Mining* (GMM), a foreign corporation, purchased an interest in Premier Chemicals, LLC (Premier), a U.S. limited liability company that was treated as a partnership for U.S. income tax purposes. From 2001 to 2008, income was allocated to GMM from Premier, and GMM paid income tax in the U.S.

In 2008, GMM's interest was redeemed by Premier, and GMM received two liquidating payments, one in July 2008 and the second in January 2009 but deemed to have been made on December 31,

2008. GMM realized gain totaling over $6.2 million, of which $2.2 million was deemed attributable to U.S. real property interests (which GMM conceded was taxable income).

GMM contends that the remainder-the "disputed gain" of $4 million-is not taxable for U.S. purposes.

GMM timely filed a Form 1120-F (U.S. Income Tax Return of a Foreign Corporation) for 2008, in which it reported its distributive share of Premier's income, gain, loss, deductions, and credits, but did not report any income it received from the redemption of its partnership interest (i.e., neither the now conceded real estate gain nor the disputed gain). GMM did not file a return or pay any income tax in the U.S. for 2009. GMM's reporting position was recommended to it by an experienced certified public accountant (CPA) who was recommended to GMM by its U.S. lawyer.

IRS prepared a substitute for return under §6020(b) for GMM's 2009 year and issued a notice of deficiency for 2008 and 2009, determining that GMM must recognize its gain on the redemption of its partnership interest for U.S. tax purposes as U.S.-source income that was effectively connected with a U.S. trade or business, consistent with Revenue Ruling 91-32. GMM sought relief in the Tax Court.

GMM argued that the redemption of its interest in Premier was a one-time, extraordinary event and so was not undertaken in the ordinary course of Premier's business. GMM argued that Premier's U.S. office is in the business of selling and producing magnesite, not buying and selling partnership interests. Because the disputed gain was realized in the redemption of GMM's partnership interest in Premier, not from Premier's ordinary business (magnesite production and sale), it did not satisfy the ordinary course requirement and was not U.S. source.

IRS disagreed with GMM's characterization of Premier, and pointed to Premier's other actions-admitting a new partner and redeeming its interests-to show that Premier's redemption of GMM's interest was not an isolated event. IRS took the position that the wording of §865(e)(2)(A) ("any sale of personal property") was broad enough to cover all sales of personal property, including occasional sales.

The Tax Court concluded that GMM's disputed gain was capital gain that was not U.S.-source income. It held that the disputed gain was not effectively connected with a U.S. trade or business.

The Tax Court declined to follow Revenue Ruling 91-32. Accordingly, GMM was not liable for U.S. income tax on the disputed gain. Revenue Ruling 91-32 held that the gain realized by a foreign partner upon disposing of its 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. In other words, Revenue Ruling 91-32 essentially adopted a §751 analysis for inventory and receivables. However, the Tax Court found that Revenue Ruling 91-32, with its extremely cursory treatment of the partnership provisions, lacked the power to persuade.

The Court noted that Revenue Ruling 91-32 did not address or analyze the question of when an office or other fixed place of business might be a material factor in the production of redemption gain. Rather, it summarily stated that the regulation, which in the non-redemption context determined whether income was realized from the active conduct of a U.S. trade or business (Regulation §1.864-4(c)(3)), and whether an asset was used in the active conduct of a U.S. trade or business (Regulation §1.864-4(c)(2)) applied. Revenue Ruling 91-32 also made no mention of the "ordinary course" prong of the "attributable to" analysis, and the Court found that this detracted from the persuasiveness of its conclusion that gain such as the disputed gain is attributable to U.S. offices.

The Tax Court found that IRS conflated the ongoing income-producing activities of Premier (magnesite production and sale), which certainly occurred in the ordinary course, and the redemption of GMM's partnership interest in Premier, which was an extraordinary event. By doing so, IRS effectively eliminated the "ordinary course" test and allowed the "material factor" test to stand for both tests.

The Court reasoned that Premier's business did regularly produce income (and GMM paid tax on its distributive share of that income each year). However, contrary to the IRS's assertion, Premier was not engaged in the business of buying or selling interests in itself and did not do so in the ordinary course of its business. Premier engaged in only two such transactions (other than the redemption of GMM's interest) over the course of seven years, and this quantum of activity was not sufficient to show that Premier was in the business of redeeming and selling partnership interests. Rather, Premier was in the business of producing and selling magnesite products. Accordingly, GMM's gain realized on the redemption of its partnership interest in Premier was not realized in the ordinary course of the trade or business carried on through Premier's U.S. offices.

The Tax Court further held that, as to the now conceded tax liability for gain on the real estate, GMM was not liable for the §6662(a) penalty for 2008 or the additions to tax under §6651(a)(1) and §6651(a)(2) for 2009, because GMM reasonably relied on the erroneous advice of the CPA.

Home Team Transition Management (2017) TC Memo 2017-51

Alleged management fees paid by a healthcare service provider to its owner were not deductible fees but rather were dividends, based on the Court's findings that the fees were not paid on account of any work performed, and were not reasonable where they varied widely in amount and were made based primarily on the availability of operating profits.

Management fees are deductible under §162 if they are ordinary, necessary and reasonable payments made for services rendered. (*RTS Inv. Corporation ,* TC Memo 1987-98; Regulation §1.162-7(a)) In RTS, a case involving the reasonableness of salaries and management fees paid by closely held corporations, the Tax Court held that the salaries and management fees paid by a subsidiary were not reasonable where, among other things, the amount paid was equally distributed to shareholders according to ownership percentages and was paid in direct relation to the subsidiary's profitability. The RTS Court noted that where a corporation is controlled by officer/employees who set their own compensation, special scrutiny must be given to such salaries.

Regulation §1.162-7(b)(1) provides that "[a]ny amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock." Regulation §1.162-7(b)(3) continues that "[i]n any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances." Thus, a taxpayer must show that the amount paid is compensation is both (1) reasonable, and (2) for services actually rendered. *(Friendly Fin., Inc.,* TC Memo 1991-551)

Home Team Transition Management (Home Team) is a healthcare service provider. Home Team was owned by Charles and Mary Honigfort and Sean and Ruth Ann Noonan (the owners) and has been an ongoing business since 1994.

Home Team was purchased on October 1, 2010 by Sacer Cor Enterprises, Inc. (Sacer), financed by, among other things, interest-bearing loans funded by the owners and a corporate bank loan. Sacer is a for-profit corporation, the shares of which were held in equal percentages by the owners.

After Sacer's acquisition of Home Care, one of the owners performed its daily administrative duties, and another handled the healthcare management responsibilities. For 2011, 2012, and 2013 (the years at issue), they both received wages from Home Care for the work performed. During the years at issue, Sacer did not pay wages or compensate any of the owners for any work performed but did periodically pay director's fees to the four owners in equal amounts.

On its returns for the years at issue, Home Team deducted $120,000, $36,000, and $42,000, claiming that it had paid those amounts to Sacer for management services. IRS disallowed these deductions in full. On its corporate returns, Sacer reported the management fees from Home Team as income.

The management fee amounts for each year were initially classified on Home Team's books as intercompany loans, but were later reclassified in whole or part as management fees. The management fee deduction for funds transferred to Sacer was primarily based on the amount of cash Sacer needed to make outside loan repayments and also on the amount of fiscal year operating profits of both entities.

Sacer's board meeting minutes from July, 2010, state that its directors will periodically review and direct the operations of entities it controls, and will "assess appropriate fees against its entities for management services performed for them or on their behalf." The board did not approve any compensation or fees during a meeting in January, 2011, due to Home Team's restricted cash flow. However, at subsequent meetings from June, 2011 to December, 2013, it approved fees ranging from $27,000 to $93,000. These amounts were not based on hours worked or services performed, but rather were based on the amount of cash Sacer required to make loan payments and the amount of cash available from Home Team's operating profits.

IRS determined that the management fees that had been deducted in reality were dividends to Sacer and accordingly disallowed Home Team's management fee deductions, resulting in tax deficiencies for the three years of $50,282, $9,951, and $12,310.

In support of its determination, IRS pointed to facts that no management services were performed by Sacer or its officers and no written agreement existed between Home Team and Sacer providing for management services.

Home Team, on the other hand, argued that Sacer's board meeting minutes reflect that management fees were intended and voted by the board for each of the years at issue, and that the amount of management fees varied each year because there was no way of knowing in advance the amount of time needed to manage Home Team.

The Tax Court found that Home Team failed to show that the deducted management fees it paid to Sacer were for services rendered or were "reasonable" under §162. The Court noted that there was no credible evidence showing that any management services were performed for Home Team and also found it telling that the alleged fees were originally booked as loan payments and that the amounts varied dependent on Home Team's revenues. Accordingly, it found no error in IRS's disallowance of the management fee deductions that Home Team claimed for 2011, 2012, and 2013.

Moneygram International, Inc. and Subsidiaries v. Commissioner, (CA 5 11/15/2016) 118 AFTR 2d ¶ 2016-5508.

The Court of Appeals for the Fifth Circuit has vacated and remanded a Tax Court decision holding that the taxpayer, a parent corporation and its subsidiaries engaged in the money services business, was not a "bank" under §581. In analyzing whether a substantial part of its business consisted of receiving "deposits" and making "loans" and discounts-the Court determined that the Tax Court had applied incorrect definitions of these terms.

Generally, if any security that is a capital asset becomes worthless during the tax year, the loss is treated as from the sale or exchange of a capital asset-that is, as a capital loss-on the last day of the tax year. (§165(g)(1)) The definition of a security includes a share of stock in a corporation; a right to subscribe for or to receive a share of stock in a corporation; or a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or its political subdivision with interest coupons or in registered form. (§165(g)(2))

However, "banks" are entitled to a bad debt deduction-deductible as ordinary income-for worthlessness (in whole or in part) of debts evidenced by a corporate or government bond, debenture, note, or certificate, or other evidence of indebtedness. (§582(a), Regulation §1.582-1(a))

Under §581, the term "bank" includes any bank or trust company incorporated and doing business under the laws of the U.S., the District of Columbia, or any state, if a substantial part of its business consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and if it is subject by law to supervision and examination by state, or federal authority having supervision over banking institutions. §581 does not define the terms "deposits" or "loans."

In *Staunton Industrial Loan Corp v. Com.,* (CA 1941) 27 AFTR 538, the Fourth Circuit concluded that an entity must manifest three basic features to come within the commonly understood definition of a bank: (1) the receipt of deposits from the general public, repayable to the depositors on demand or at a fixed time; (2) the use of deposit funds for secured loans; and (3) the relationship of debtor and creditor between the bank and depositor.

MoneyGram International, Inc. is the parent of a group of companies that operate a global payment services business. This business is conducted chiefly through MoneyGram Payment Systems, Inc. (MPSI), a wholly owned subsidiary. The Tax Court referred to the parent corporation and its subsidiaries, including MPSI, as MoneyGram.

MoneyGram's business involves the movement of money through three main channels: money transfers, money orders, and payment processing services. MoneyGram is registered with the Department of the Treasury as a "money services business," a category that includes money transmitters, check cashing services, issuers and sellers of money orders, and issuers and sellers of traveler’s checks.

During 2007 and 2008, MoneyGram undertook a recapitalization that included writing down or writing off a substantial volume of partially or wholly worthless securities. MoneyGram claimed bad debt deductions under §166(a) with respect to "non-real-estate mortgage investment conduit" (non-REMIC) asset-backed securities. It claimed ordinary loss deductions on the disposition of these securities under §582 -a treatment available only to banks.

On audit, IRS disallowed the ordinary loss deductions on the ground that MoneyGram did not qualify as a bank. The taxpayer sought relief in the courts.

The Tax Court concluded that during 2007 and 2008 MoneyGram did not qualify as a "bank" under §581 because (1) it did not display the essential characteristics of a bank as that term was commonly understood; and (2) a substantial part of its business did not consist of receiving bank deposits or making bank loans. Accordingly, because MoneyGram was not a "bank" under §581, it was ineligible to claim ordinary loss deductions on account of the worthlessness of its securities under §582. (*Moneygram International, Inc. and Subsidiaries,* (2015) 144 TC No. 1)

In reaching this conclusion, the Tax Court held that "deposits" are "funds that customers place in a bank for the purpose of safekeeping," that are "repayable to the depositor on demand or at a fixed time," and which are held "for extended periods of time." The Tax Court held that money received by

MoneyGram as part of its money order and financial services segments did not meet this definition because MoneyGram did not hold these funds for safekeeping or for an extended period of time.

The Tax Court held that a "loan" is an agreement, "memorialized by a loan instrument" that "is repayable with interest," and that "generally has a fixed (and often lengthy) repayment period." The Tax Court held that the agreements entered into between MoneyGram and its agents did not meet this definition and were therefore not loans. The Tax Court focused on the fact that the instrument used to memorialize this agreement was facially a trust agreement and not a loan agreement, and did not charge interest.

In its majority opinion, the Fifth Circuit found that the Tax Court incorrectly defined the terms "deposits" and "loans" in §581.

The Court concluded that there was no valid support for the Tax Court's position that the definition of "deposit" includes the requirement that funds be placed for an extended period of time.

The Fifth Circuit noted that courts have repeatedly stated that interest was not required for there to be a loan. Rather, the central inquiry for determining if a transaction was a bona fide loan for tax purposes was whether it was the intention of the parties that the money advanced be repaid. The Fifth Circuit has endorsed a non-exhaustive seven-factor test to determine the factual question of whether the parties to a transaction intended it to be a loan: (1) whether the promise to repay is evidenced by a note or other instrument; (2) whether interest was charged; (3) whether a fixed schedule for repayments was established; (4) whether collateral was given to secure payment; (5) whether repayments were made; (6) whether the borrower had a reasonable prospect of repaying the loan and whether the lender had sufficient funds to advance the loan; and (7) whether the parties conducted themselves as if the transaction were a loan. (*Todd v. C.I.R., (*CA 5 2012) 110 AFTR 2d 2012-5606)

In addition to applying these incorrect definitions, the Fifth Circuit pointed out that the Tax Court had not addressed whether MoneyGram made "discounts" and on remand directed it to consider whether MoneyGram satisfied this component of §581.

In a dissenting opinion, Judge Wiener concluded that the Court must hold that MoneyGram was not a bank under §581. Regardless of what the Tax Court said about deposits being for an extended period of time, a "deposit" needed to be made for purposes of safekeeping. MoneyGram could not meet this requirement: MoneyGram's customers purchased a product, a money order. They did not "deposit" funds for safekeeping. And regardless of the Tax Court's consideration of whether MoneyGram charged interest, MoneyGram's purported "loans" were facially trust agreements, a fact which precluded a finding that MoneyGram made loans. Moreover, there could be no "discounts" absent "loans," and since MoneyGram could not show that it made loans in the banking context, there was no need to address this issue.

New Millennium Trading, LLC, TC Memo 2017-9.

Partnership was created exclusively for tax avoidance purposes and so was not recognized as an entity for Federal tax purposes. Accordingly, the Court sustained IRS's partnership-item adjustments and partnership-level determinations, as well as IRS's determination that the §6662 accuracy-related penalty applied.

Under §7701(a)(2), a partnership includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not a trust or estate or a corporation. A partnership also must have at least two members. (Regulation §301.7701-1) The term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. (Regulation §301.7701-1(a)(2)) However, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes.

In *Commissioner v. Culbertson,* (S Ct 1949) 37 AFTR 1391, the Supreme Court concluded that a joint undertaking resulted in a partnership where its members: (a) intended to join together to carry on a trade or business for their common benefit; (b) contributed property or services; and (c) had a community of interest in profits. Persons were not treated as partners unless they intended to form a partnership, but their intent was tested by objective factors such as their agreement, their conduct (including their participation in the management and operations of the business), their statements, the testimony of disinterested persons, their relationship, their respective abilities and capital contributions, the actual control of income and the purposes for which it was used, and any other facts throwing light on their true intent.

Taxpayers are subject to a 20% accuracy-related penalty for an underpayment of tax required to be shown on a return. (§6662(a)) However, under §6664(c)(1), there is an exception to the §6662(a) accuracy-related penalty for any portion of an underpayment if the taxpayer shows that there was reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion. Reliance on the advice of a tax professional may establish reasonable cause and good faith. The taxpayer claiming reliance on a tax professional must prove that: (1) the adviser was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer provided necessary and accurate information to the adviser; and (3) the taxpayer actually relied in good faith on the adviser's judgment. (*Neonatology Associates,* (2000) 115 TC 43, aff'd (CA 3 2002) 90 AFTR 2d 2002-5442)

Andrew Filipowski founded Platinum Technology, Inc. (Platinum), a computer software company, in 1987. As of February of 1999, he was Platinum's president and chief executive officer and owned 4,652,068 voting shares. By May of 1999 Platinum had reached $1 billion in revenue and had become the eighth-largest computer software company in the world.

In March of 1999, Platinum was acquired by Computer Associates International, Inc., for approximately $3.5 billion (Platinum sale). Mr. Filipowski expected to receive combined capital gains and ordinary income of $110 million from the Platinum sale.

Seeking to minimize the tax impact of the sale, Mr. Filipowski participated in a tax shelter promoted by Sentinel Advisors, LLC (Sentinel), which was managed by Ari Bergmann. In the transaction, a taxpayer (such as Mr. Filipowski) contributed offsetting options to a limited liability company (such as New Millennium Trading, LLC (NMT)), which was treated as a partnership for income tax purposes, to get an artificially high basis in a partnership interest, receive euro and stock in disposition of that interest, and then claim a significant tax loss from the disposition of the euro and stock, offsetting millions of dollars of gain realized on the sale of an unrelated business interest.

The "spread transaction" tax shelter developed by BDO Seidman, LLP (BDO) and Sentinel had the following steps: (1) creation of an option spread by the simultaneous purchase of a call option on an asset at a certain strike price and the sale of a call option on the same asset but at a slightly higher strike price; (2) transfer of the option spread and cash to a partnership; (3) claiming a basis in the partnership equal to the premium purportedly paid for the purchased option and cash contributed, without reduction for the offsetting liability related to the sold option; (4) withdrawal from the partnership and receipt of a distribution of property with a basis substituted from the basis claimed in the partnership; and (5) disposition of the distributed property. For an ordinary loss on the spread transaction, the participant would receive euro, while, for a capital loss, the participant would receive Xerox stock.

On audit, IRS issued a notice of final partnership administrative adjustment (FPAA) with respect to NMT for its 1999 tax year. In the FPAA, IRS determined that NMT was a sham and should be disregarded for Federal income tax purposes. As a result, IRS made adjustments to the loss, deduction, contribution, and distribution items NMT reported on its return and imposed a §6662 accuracy-related penalty.

The taxpayer argued that NMT met the test for partnership recognition under Culbertson, and that it needed only to show that the partners had a business purpose for joining together to conduct their business activity. NMT was a valid partnership because all of its partners were at least partially motivated to earn a profit by joining the partnership. It engaged in substantial business activity that held a reasonable likelihood of earning a profit. Further, the counterparties to its trading activities treated it as a valid partnership. As an alternative argument, the taxpayer contended that NMT must be respected as a partnership because at least two of its members invested in NMT to earn profits from a rise in the euro.

On the other hand, IRS argued that NMT should be disregarded as a partnership under Culbertson. IRS contended that the District of Colombia Circuit has established a bright-line test that a partnership must pass to be respected. That test requires the entity to show that "the parties intended to join together as partners to conduct business activity for a purpose other than tax avoidance" (citing *ASA Investerings Partnership, et al. v. Commissioner,* (CA DC 2/01/2000) 85 AFTR 2d 2000-675). And even if the D.C. Circuit did not have a bright-line test, NMT should be disregarded as a partnership under any facts and circumstances sham partnership test because: (1) NMT partners withdrew after a short period, (2) these partners withdrew consistent with a plan, (3) a single-purpose entity was set up just to conduct the transaction at issue, (4) no consideration was given to structuring the transaction other than how it was structured, and (5) the transaction could have been done at a lower cost without the partnership.

The Tax Court found that the evidence was overwhelming that NMT was created exclusively for tax avoidance purposes and so was not recognized as an entity for Federal tax purposes. Accordingly, it could not elect to be taxed as a partnership. The Court sustained IRS's partnership-item adjustments and partnership-level determinations, as well as IRS's determination as to the §6662 accuracy-related penalty.

The Tax Court reasoned that because NMT could not be classified as a partnership for Federal tax purposes, there was no partnership loss, no partnership deductions, no contributions to the purported partnership, and no distributions from a partnership to its purported partners. As a result, adjustment of those partnership items to zero was appropriate. Furthermore, because NMT was not a tax-recognized entity, none of its members could have any membership interest in NMT in which they could have any tax basis. When a partnership is disregarded for tax purposes, the rules of subchapter K of chapter 1 of the Code no longer apply, and the partnership's activities will be deemed to have been engaged by one or more of its purported partners. A disregarded partnership has no identity separate from its owners, and the Tax Court treated it as an agent or nominee.

The Court found the following in analyzing the transaction. Mr. Filipowski's interactions with NMT were preplanned and followed the spread transaction steps outlined in the Sentinel presentation. Mr. Filipowski set up two single-purpose entities, the trust and AJF-1, to engage in the NMT spread transaction. AJF-1 participated in NMT for only a brief time, withdrawing three months after it executed the subscription agreement for the first time. All of the other NMT participants withdrew in just over a year after NMT was formed. NMT was created in August of 1999 and terminated operation in October of 2000.

The Court also found that nothing in the record suggested that consideration was given to conducting NMT's activity through anything other than a partnership, because a partnership was necessary to claim the tax benefits. The transactions undertaken by AJF-1 could have been undertaken outside of NMT at a lower cost. AJF-1 could have directly engaged in the same type of activity that NMT engaged in without contracting to pay $4.2 million in fixed fees. By keeping the option spread under the consulting agreement with (a limited liability company owned and controlled by Sentinel), AJF-1 could have invested under Mr. Bergmann's management at a lower cost without using NMT. The variable fees paid to Shomrim were less than the NMT variable fees, and Mr. Bergmann managed both NMT and the activity under the Shomrim agreement.

The Tax Court also rejected the taxpayer's alternate argument (that two of its members invested in NMT to earn profits from a rise in the euro). It reasoned that large guaranteed tax benefits combined with the possibility of making a relatively small profit did not create a valid business purpose. The other foreign currency trades that NMT made were significantly smaller in amount compared to the option spread and were an obvious attempt to legitimize NMT's status as a partnership. The only significant trade was most likely to expire worthless. Moreover, the taxpayer presented no evidence other than self-serving testimony to the effect that the partners had a legitimate profit motive.

In analyzing if there was an exception to the accuracy-related penalty because of the taxpayer's reliance on a tax advisor, the Court noted that reliance may be unreasonable if the adviser is a promoter of the transaction or suffers from an inherent conflict of interest that the taxpayer knew or should have known about. The Tax Court found that the taxpayer did not show that its managing member, Shakti Advisor, LLC (Shakti), reasonably relied on its return preparer to prepare NMT's 1999 return. The taxpayer also failed to demonstrate that the managing member provided necessary and accurate information to the return preparer or that the preparer relied in good faith on any advice that was provided.

The Court rejected the taxpayer's argument that NMT had a reasonable basis for treating itself as a partnership. In assessing whether NMT had reasonable cause, the Court examined Shakti's role as NMT's managing partner and tax matter partner. The Court focused on the conduct of Mr. Bergmann (who was one of Sentinel's founders and who owned a 75% controlling interest in Shakti). The Court concluded that Mr. Bergmann, through Shakti, did not act with reasonable cause and good faith in filing the NMT 1999 return, and so the gross valuation penalty applied. Mr. Bergmann was a highly sophisticated C.P.A. with significant tax experience. Mr. Bergmann, through Shakti, was involved in executing the NMT spread transaction and managing NMT. The option spread contributed to NMT was structured to yield and did yield tax benefits which Mr. Bergmann should have recognized as "too good to be true." The taxpayer spent $1.2 million to purchase the option spread and reaped approximately $120 million in taxable losses. A reasonably prudent person, with Mr. Bergmann's C.P.A. background and tax experience, would not have conducted himself as he did in promoting and facilitating the tax losses arising out of the NMT spread transaction.

Santander Holdings USA, Inc. v. U.S., (CA 1 12/16/2016) 118 AFTR 2d ¶2016-5579.

The Court of Appeals for the First Circuit, reversing a district court, has concluded that the "trust" component of a Structured Trust Advantaged Repackaged Securities (STARS) transaction, which involved the participating bank transferring assets to a disregarded foreign trust and claiming credits for foreign taxes paid, lacked economic substance. The First Circuit found that the trust transaction had no legitimate business purpose and, absent the generation of foreign tax credits, provided no objective economic benefit.

To determine whether a transaction has economic substance, courts usually make a two-pronged factual inquiry:

1. Was the taxpayer motivated by no business purpose (other than getting tax benefits) in entering into the transaction? (Subjective test)

2. Did the transaction have objective economic substance, i.e., was there a reasonable possibility of a profit? (Objective test) (*Frank Lyon Co v. U.S.,* (S Ct 1978) 41 AFTR 2d 78-1142)

The economic substance doctrine allows the government to look beyond technical compliance with the Code to ascertain the real nature of the transaction at issue.

The Circuits have differed in their application of the two-prong test. The Fourth Circuit requires only that a transaction have either a subjective business purpose or objective economic substance in order to be respected (the disjunctive test). (Rice's *Toyota World Inc. v. Commissioner,* (CA 4 1985) 55 AFTR 2d 85-580) On the other hand, the Eleventh Circuit (*United Parcel Service of America Inc.,* (CA 11 2001) 87 AFTR 2d 2001-2565), the Federal Circuit (*Coltec Industries Inc. v. U.S.,* (Ct Fed Cl 2004) 94 AFTR 2d 2004-6708), the Sixth Circuit (*Dow Chemical CO v. U.S.,* (CA 6 2006) 97 AFTR 2d 2006-671), and the Fifth Circuit (*Klamath Strategic Investment Fund v. U.S.,* (CA 5 2009) 103 AFTR 2d 2009-2220) require both (the conjunctive test).

Observation: For transactions entered into after March 30, 2010-i.e., after the time period involved in this case-the *Health Care and Education Reconciliation Act* (P.L. 111-152, 3/30/2010) added §7701(o). It provides that a transaction is treated as having economic substance under a conjunctive two-prong test only if, apart from Federal income tax effects, both: (1) the transaction changes the taxpayer's economic position in a meaningful way; and (2) the taxpayer has a substantial purpose for entering into the transaction. That is, the taxpayer's non-Federal-income-tax purpose for entering into a transaction must be "substantial."

Both the U.S. and foreign countries may tax the foreign source income of U.S. taxpayers. To ease this double taxation burden, the Code permits most U.S. taxpayers who pay income taxes to a foreign country to either deduct the taxes from gross income for U.S. purposes or credit them dollar for dollar against their U.S. income tax liability on foreign source income. (§901)

Legislative history provides that the foreign tax credit "was originally designed to produce uniformity of tax burden among United States taxpayers, irrespective of whether they were engaged in business in the United States or business abroad."

Sovereign Bancorp, Inc. (Sovereign), which was later known as Santander Holdings USA, Inc., engaged in a STARS transaction promoted by the U.K.-chartered Barclays Bank PLC (Barclays). As described by the court, the transaction featured Barclays receiving substantial benefits under U.K. tax laws and lending funds to U.S. banks at a lower cost than otherwise might be available to them.

As part of the STARS transaction, Sovereign created a trust to which it contributed $6.7 billion of income-generating assets. The trustee of the trust was made a U.K. resident so that the trust's income was subject to U.K. income tax at a 22% rate. The trust income was also subject to U.S. income tax and was attributed to Sovereign. Sovereign paid the U.K. taxes and then claimed a foreign tax credit under §901 in calculating its U.S. income tax liability. This component of the transaction was referred to by the court as the "trust transaction."

Over the course of a year, Barclays acquired a $1.15 billion interest in the trust, which it was required to sell back to Sovereign, for $1.15 billion, at the end of the transaction. Sovereign treated the $1.15 billion as a loan and claimed interest deductions on it. The trust engaged in certain actions that generated a U.K. tax benefit for Barclays in exchange for which Barclays made a monthly payment (the "Barclays payment") equal to half of the amount of U.K. taxes paid by Sovereign on the trust's income that Sovereign netted against its interest obligation on the purported loan (the "loan transaction").

IRS disallowed foreign tax credits claimed by Sovereign for 2003, 2004, and 2005. IRS claimed that the Barclays payment was effectively a rebate of the U.K. taxes paid, in that it relieved Sovereign of half the burden of its U.K. taxes, and further claimed that the STARS transaction as a whole was a sham without economic substance. Sovereign sued to recover $234 million in federal income taxes, penalties, and interest.

In 2013, a Massachusetts district court granted Sovereign partial summary judgment that the Barclays payment should be accounted for as revenue to Sovereign in assessing whether Sovereign had a reasonable prospect of profit in the STARS transaction. For more details on this decision.

Sovereign then moved for summary judgment on its claims for refunds of taxes paid in 2003, 2004, and 2005, as well as deficiency interest assessed by IRS. The district court again sided with Sovereign, upholding the legitimacy of both the trust and loan transactions and allowing Sovereign to claim interest deductions and foreign tax credits for the U.K. taxes paid. The court also found that, since the credits and interest deductions were properly claimed, Sovereign should not be assessed penalties. For more details.

The district court's allowance of tax credits was in conflict with a number of other decisions involving similar transactions, including from the Second Circuit *(Bank of New York Mellon Corporation v. Commissioner*, (CA 2 2015) 116 AFTR 2d 2015-6014) and the Federal Circuit (*Salem Financial, Inc. v. U.S.,*. (CA Fed Cir 2015) 115 AFTR 2d 2015-1835). Additionally, a district court in the Eighth Circuit found that a similar STARS transaction lacked economic substance. (*Wells Fargo & Co. v. U.S.,* (DC MN 2015) 116 AFTR 2d 2015-6738)

Through a number of concessions made by both parties, the focus of the appeal was essentially limited to the validity of the trust transaction.

The Court of Appeals for the First Circuit found that the district court committed reversible error and that the government was entitled to summary judgment as to the economic substance of the trust transaction.

The Appellate Court noted that it did not matter how the Barclays payment was characterized (i.e., rebate or income) because, regardless, the trust transaction itself did not have a reasonable prospect of creating a profit without considering the foreign tax credits and thus is not a transaction for which Congress intended to give such a benefit. The First Circuit found that the transaction was shaped solely by tax avoidance features, lacked a bona fide business purpose, and was "profitless," in that the purported profit from the Barclays payment was more than negated by the costs of the transaction. The entire function of the trust transaction was exposure to U.K. taxation in order to generate foreign tax credits, which does not "advance the Tax Code's interest in providing foreign tax credits in order to encourage business abroad or in avoiding double taxation."

The First Circuit also found it telling that the trust transaction lacked any real economic risk, as Barclays and Sovereign both had contractual remedies and took other steps to minimize such risk. It also noted that Sovereign's U.K. tax liability was artificially generated through a series of "circular cash flows" through the trust, which, as noted above, existed just to generate the desired tax effect.

Accordingly, the First Circuit reversed the district court's decision as to the economic substance of the trust transaction and the foreign tax credits claimed.

Scott Singer Installations, Inc. AOD 2017-04,04/17/2017.

IRS has acquiesced in result only with a Tax Court holding that an S corporation's payment of personal expenses on behalf of its sole shareholder/officer should not be characterized as wages subject to federal employment taxes. The Tax Court found that they were repayments of loans made to the S corporation, and IRS was critical of the Court's reasoning.

The proper characterization of transfers by shareholders to corporations, as either loans or capital contributions, is made by reference to all the evidence, and the burden of proving that a transfer is a loan falls on the taxpayer. (*Dixie Dairies Corporation ,* (1980) 74 TC 476)

Courts have established a nonexclusive list of factors to consider when evaluating the nature of transfers of funds to closely held corporations. Such factors include:

1. The names given to the documents that would be evidence of the purported loans;
2. The presence or absence of a fixed maturity date;
3. The likely source of repayment;
4. The right to enforce payments;
5. Participation in management as a result of the advances;
6. Subordination of the purported loans to the loans of the corporation's creditors;
7. The intent of the parties;
8. The capitalization of the corporation;
9. The ability of the corporation to obtain financing from outside sources;
10. Thinness of capital structure in relation to debt;
11. Use to which the funds were put;
12. The failure of the corporation to repay; and
13. The risk involved in making the transfers. (Calumet Indus., Inc., (1990) 95 TC 257)

The inquiry before a court is "whether the transfer... constitutes risk capital entirely subject to the fortunes of the corporate venture or a strict debtor-creditor relationship." (*Dixie Dairies Corporation* 74 TC 476 (1980)) Transfers to closely-held corporations by controlling shareholders are generally subject to heightened scrutiny.

For employment tax purposes, "wages" are defined as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions not applicable to this case. (§3121(a), §3306(b), and §3401) Employment is defined generally as any service, of whatever nature, performed by an employee. (§3121(b))

Mr. Singer was the sole shareholder and president of an S corporation called Scott Singer Installations, Inc. (the corporation), and served as its sole corporate officer. The corporation was primarily engaged in servicing, repairing, and modifying recreational vehicles. Mr. Singer worked full time for the corporation and occasionally employed a service technician, two laborers, and an individual to help with the corporation's Internet sales.

Between 2006 and 2008, Mr. Singer advanced a total of $646,443 to the corporation to fund business growth. The corporation struggled from 2009 to 2011 and Mr. Singer borrowed another $513,099, which he advanced to the corporation. Mr. Singer also began charging business expenses to personal credit cards. The corporation reported operating losses of $103,305 for 2010 and $235,542 for 2011. During these years, the corporation paid $181,872 of Mr. Singer's personal expenses by making payments from its bank account to Mr. Singer's creditors.

All of the advances were reported as shareholder loans on the corporation's general ledgers and Form 1120S (U.S. Income Tax Return for an S Corporation), but there were no promissory notes between Mr. Singer and the corporation, there was no interest charged, and there were no maturity dates imposed. The corporation did not deduct the payment of Mr. Singer's personal expenses on Form 1120S.

The corporation filed Form 940 (Employer's Annual Federal Unemployment (FUTA) Tax Return) and Forms 941 (Employer's Quarterly Federal Tax Return) and paid employment taxes on wages paid to each employee except Mr. Singer. The corporation did not report paying wages to Mr. Singer during 2010 or 2011.

On audit, IRS determined that Mr. Singer was an employee of the corporation for 2010 and 2011 and that the $181,872 in payments the corporation made on his behalf constituted wages that should have been subject to employment taxes. Mr. Singer did not object to being classified as an employee of the corporation, but contended that the advances that he made to the corporation were loans and that the payments the corporation made on his behalf represented repayments of those loans. IRS, on the other hand, argued that the funds advanced to the corporation were contributions to capital.

The Court concluded that Mr. Singer intended his advances to be loans, that his intention was reasonable for a substantial portion of the advances, and that the corporation's repayments of those loans were valid and should not be characterized as wages subject to employment taxes. (*Scott Singer Installations, Inc.,* TC Memo 2016-161)

The Court said that there were a number of factors involved when evaluating the nature of transfers of funds to closely held corporations. It believed that the ultimate question was whether there was a genuine intention to create a debt, with a reasonable expectation of repayment, and whether that intention comported with the economic reality of creating a debtor-creditor relationship. If there was a genuine intention to create a debt, the corporation's payment of Mr. Singer's personal expenses could be considered as partial repayment of Mr. Singer's loans rather than as wage income.

The Court noted that the corporation consistently reported the advances as loans on its general ledgers and on Forms 1120S. The corporation also consistently reported the expenses it was paying on behalf of Mr. Singer as a repayment of shareholder loans rather than reporting the payments as deductible business expenses. The Court said this indicated that Mr. Singer and the corporation intended to form a debtor-creditor relationship and that the corporation conformed to that intention. In addition, the Court pointed out that the corporation's payments on behalf of Mr. Singer were consistent regardless of the value of the services Mr. Singer provided to the corporation. Many of the payments the corporation made were for Mr. Singer's recurring monthly expenses, including home mortgage and personal vehicle loan payments. The consistency of these payments, both in time and in amount, was characteristic of a debt repayment.

Furthermore, the fact that the corporation made payments when it was operating at a loss strongly suggested that a debtor-creditor relationship existed: a creditor expects repayment of principal and compensation for the use of money, while an investor understands that any return of his investment depends on the success of the business.

The Court also said that Mr. Singer had a reasonable expectation of repayment of the advances when he first advanced funds to the corporation between 2006-2008. At that time, the business was well-established and successful. The Court believed that because the corporation was operating profitably and showed signs of growth, Mr. Singer was reasonable in assuming his loans would be repaid and that such intention comported with the economic reality of creating a debtor-creditor relationship.

The Court, however, did not believe Mr. that Singer had a reasonable expectation that the loans he made after 2008 would be repaid as the corporation's business had dropped off sharply. It therefore concluded that the advances made in 2008 and earlier were bona fide loans and that advances made after 2008 were capital contributions.

IRS has now announced its acquiescence in result only as to whether the corporation's payment of personal expenses on behalf of its sole shareholder-corporate officer constitutes wages subject to Federal employment. IRS had many criticisms of the Tax Court's reasoning.

IRS said that the critical factor in determining the appropriate tax treatment is whether the payments are remuneration for services provided to the employer. IRS disagreed with the Court's reasoning. Whether advances made to a corporation by a shareholder-officer are characterized as loans rather than capital contributions does not control whether a payment made by the corporation to the shareholder-officer is compensation for services and therefore properly characterized as wages. The Court failed to acknowledge that, similar to debt repayments, wages are also paid in a recurring nature and may be paid even if a business is operating at a loss.

IRS noted that there is no provision in the Code or regulations that authorizes an employee to waive his or her right to receive wages, and thereby characterize payments that are made to the employee or benefits that are provided to the employee as something other than wages.

IRS said that, in focusing on the intention to create a debtor-creditor relationship and whether Mr. Singer had a reasonable expectation of repayment of the advances, the Court failed to analyze or even cite the relevant statutory or regulatory provisions governing the definition of wages for Federal employment tax purposes. Nor did the Court review its own substantial body of case law that repeatedly rejects taxpayers' attempted characterizations of payments to officers who perform substantial services as something other than compensation for services. The Court failed to analyze why precedents concerning officer compensation were not applicable. IRS said that, for example, Smith, TC Memo 1995-410, found that payments of personal living expenses made by a wholly owned corporation on behalf of its president/employee and sole shareholder, who received no salary in the year at issue, are properly characterized as wages when they represent remuneration for employment. And, several circuit courts have also rejected arguments that officers who perform substantial services received something other than compensation for those services.

IRS said that, while none of the courts in the cases cited above found the existence of a debtor-creditor relationship, the applicable employment tax rules defining the scope of wages as all remuneration for employment does not cease to apply even if such debtor-creditor relationship is present. While IRS may recognize a payment from a corporation to its shareholder-officer who is also an employee as a loan repayment, the taxpayer must provide objective evidence that both substantiates that a bona fide loan exists between the parties and substantiates that the payment from the taxpayer to the employee was specifically in repayment of that loan and is separate from compensation paid to the employee for the performance of services for the taxpayer.

Accordingly, unless a taxpayer objectively substantiates both the existence of a loan and that payments made were in repayment of that loan, IRS will continue to assert that the payment of personal expenses by an S Corporation on behalf of its corporate officer/employee constitute wages subject to Federal employment taxes.

Seaview Trading LLC, (CA 9 6/7/2017) 119 AFTR 2d ¶ 2017-827.

The Court of Appeals for the Ninth Circuit, affirming the Tax Court, has held that a disregarded entity that is a partner in a partnership: a) is treated as a pass-thru partner and thus precludes the partnership from qualifying for the small partnership exception to the TEFRA audit rules; and b) can be the partnership's tax matters partner.

For the years at issue in this case, IRS audits and related activities involving the tax treatment of partnership items and affected items are done at the partnership level under the unified partnership audit procedures. These procedures apply to all partnerships other than certain small partnerships and electing large partnerships. (§6221 through §6234) Congress enacted the unified partnership audit and litigation procedures as part of the *Tax Equity and Fiscal Responsibility Act of 1982* (TEFRA, P.L. 97-248).

The unified audit rules do not apply to any partnership having 10 or fewer partners, each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner, unless the partnership elects to have them apply. (§6231(a)(1)(B)) This small partnership exception does not apply if any partner during the tax year is a "pass-thru partner" (Regulation §301.6231(a)(1)-1(a)(2)), i.e., a partnership, estate, trust, S corporation, nominee or other similar person through whom other persons hold an interest in the partnership. (§6231(a)(9))

If IRS reasonably but erroneously determines, based on the partnership's return for a tax year, that the TEFRA unified audit provisions apply to the partnership for the year, then those provisions will be extended to that partnership (and its items) for that tax year and to partners of the partnership. (§6231(g)(1))

Within 90 days of receiving a final partnership administrative adjustment (FPAA), the partnership's tax matters partner may petition a court for readjustment of the partnership items for a tax year. (§6226(a)) Where a partnership does not designate a tax matters partner, the tax matters partner is the general partner having the largest profits interest. (§6231(a)(7)(B))

Observation: The Bipartisan Budget Act of 2015 (the BBA) repealed the TEFRA uniform partnership audit rules and replaced them with a streamlined single set of rules for auditing partnerships and their partners at the partnership level. However, these BBA rules do not apply to the tax years involved in this case.

Under Regulation §301.7701-3 ("check the box regulations"), "an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner." Regulation §301.7701-3(b)(1)(ii) provides that a domestic eligible entity with a single owner will be "disregarded as an entity separate from its owner" by default, unless the entity chooses otherwise. The activities of a disregarded entity "are treated in the same manner as a sole proprietorship, branch, or division of the owner," except in regard to the application of certain special employment and excise tax rules. (Regulation §301.7701-2(a))

With exceptions not relevant here, unless the entity elects otherwise, a domestic entity with two or members is treated as a partnership for tax purposes. (Regulation §301.7701-3(b)(1)(i))

Under the Skidmore deference doctrine (based on the Supreme Court decision in *Skidmore v. Sift & Co.,* (Sup Ct 1944) 323 U.S. 134), an agency's ruling "is eligible to claim respect according to its persuasiveness."

Robert Kotick (Kotick) and his father Charles Kotick (C. Kotick) formed a limited liability company (LLC), Seaview Trading, LLC (Seaview). For tax purposes, Seaview was a partnership. The Koticks each held their respective interests in Seaview through LLCs: AGK Investments LLC (AGK), owned wholly by Kotick, and KMC Investments LLC (KMC), owned wholly by C. Kotick. AGK and KMC were disregarded entities under Regulation §301.7701-3(b)(1)(ii). AGK owned 99.15% of Seaview, and KMC owned the remainder.

Seaview acquired an interest in a common trust fund, which in 2001 reported a loss that was allocated to its investors - including Seaview.

Seaview failed to designate a tax matters partner for 2001.

IRS began an audit of Seaview in October 2005. Five years later, in October 2010, IRS issued an FPAA notice disallowing the loss from Seaview's trust investment and imposing penalties. Kotick filed a petition in Tax Court on behalf of Seaview challenging IRS's notice in regard to Seaview's 2001 taxes.

Kotick argued that IRS's notice was invalid because Seaview was exempt from the otherwise-applicable partnership audit procedures pursuant to the small-partnership exception set forth at §6231(a)(1)(B).

IRS moved to dismiss Kotick's petition for lack of jurisdiction, arguing that (1) Seaview did not fall within the §6231 small-partnership exception, and (2) Kotick lacked standing to file the petition on behalf of Seaview because he was not Seaview's tax matters partner. The Tax Court granted IRS's motion. Kotick appealed to the Ninth Circuit.

The Court rejected Seaview's argument that, under Regulation §301.7701-3, AGK and KMC were disregarded entities treated as sole proprietorships of their respective individual owners, and that consequently they could not constitute pass-thru partners within the meaning of Regulation §301.6231(a)(1)-1.

IRS directly addressed the question of whether a disregarded entity may constitute a pass-thru partner in Revenue Ruling 2004-88, 2004-2 CB 165. Revenue Ruling 2004-88 starts by emphasizing that the definition of a "pass-thru" partner contained in §6231(a)(9) includes "nominee[s] or other similar person through whom other persons hold an interest in the partnership." The Court here said that, in other words, the definition expressly contemplates its application beyond the specific enumerated forms. Single-member LLCs are indisputably entities "through whom other persons hold an interest in [a] partnership." The question, therefore, is whether a single-member LLC constitutes a "similar person" in respect to the enumerated entities. Revenue Ruling 2004-88 holds that the requisite similarity exists when "legal title to a partnership interest is held in the name of a person other than the ultimate owner." In support of this holding, Revenue Ruling 2004-88 cites *White,* TC Memo 1991-552, in which the custodian for minor children was not a pass-thru partner because it did not hold legal title to the children's partnership interests. Revenue Ruling 2004-88 contrasts that result with the outcome in *Primco Management Co.,* TC Memo 1997-332, in which a grantor trust holding legal title to an interest in an S corporation constituted a pass-thru shareholder.

Revenue Ruling 2004-88 then goes on to state that, although the LLC-partner in the Ruling was a disregarded entity for federal tax purposes, it was a partner of P (the partnership) under the law of the state in which P was organized. Similarly, although A, LLC's owner, was a partner of P for purposes of the TEFRA partnership provisions under §6231(a)(2)(B) because A's income tax liability was determined by taking into account indirectly the partnership items of P, A was not a partner of P under state law. Revenue Ruling 2004-88 concluded that the small partnership exception did not apply to P because P had a partner that was a pass-thru partner.

Seaview argued that Revenue Ruling 2004-88 's analysis impermissibly treats state law as determinative of federal tax consequences, in contravention of Regulation §301.7701-1(a)(1), *Littriello,* (CA 6 2007) 99 AFTR 2d 2007-2210, and *Hecht v. Malley,* (S Ct 1924) 4 AFTR 3976. The Court said that each of Seaview's cited sources stands for the proposition that state business classifications do not supersede federal classifications for the purpose of assessing federal taxes. For example, Regulation §301.7701-1(a)(1) provides, "Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law."

The Court disagreed with Seaview's argument. It said that the issue here was not whether IRS may use state-law entity classifications to determine federal taxes. Rather, the question was whether an LLC's federal classification for federal tax purposes negates the factual circumstance in which the owner of a partnership holds title through a separate entity. In other words, state law is relevant to Revenue Ruling 2004-88 's analysis only insofar as state law determines whether an entity bears the requisite similarity to the entities expressly enumerated in §6231(a)(9) -that is, whether an entity holds legal title to a partnership interest such that title is not held by the interest's owner.

The Court said that Revenue Ruling 2004-88 is buttressed by Chief Counsel Advice 200250012, in which IRS Chief Counsel stated that the test for whether an entity is a "similar person" under §6231(a)(9) is simply whether title to the partnership interest is held through another person regardless of that person's tax classification. The CCA acknowledges the check-the-box regulations' sections providing for classification of entities for federal tax purposes, and establishing that a given entity may be "disregarded as an entity separate from its owner," but reasons that the non-exclusive definition of pass-thru partners contained in §6231(a)(9) "indicates Congressional intent to make the TEFRA procedures apply whenever indirect partners exist whose identity will not be reflected on the face of the partnership return." It also noted that the regulation establishing certain entities as "disregarded" did not exist at the time that Congress enacted either the small-partnership exception or the pass-thru partner provision.

The CCA concludes by further justifying the rule from Primco on the ground that "any other rule would be unworkable." Treating disregarded single-member LLCs as pass-thru partners avoids requiring IRS "to investigate the chain of ownership down two or more levels in order to determine whether TEFRA applies," and is thus consistent with §6231(g), which the CCA says, "indicates that IRS may rely upon the facts reported on a partnership return in determining whether TEFRA applies, if such reliance is reasonable."

The Court concluded that Seaview provided no compelling reason to contravene the consistent stance of IRS and the Tax Court, which have uniformly treated disregarded single-member LLCs as pass-thru partners. And, it said, IRS has taken a consistent position regarding the treatment of disregarded entities as pass-thru partners, supported by reasoning set forth in both informal and formal statements. Revenue Ruling 2004-88 is thus entitled to deference under Skidmore. Moreover, Seaview's expansive reading of the consequences of an entity's disregarded status under Regulation §301.7701-2 conflicts with the logical interpretation of a pass-thru partner as one that holds title to a partnership interest but is not the interest's ultimate owner-an interpretation that accords with the nature of the enumerated entities in §6231(a)(9) and the provision's concern with entities "through whom other persons hold an interest in the partnership."

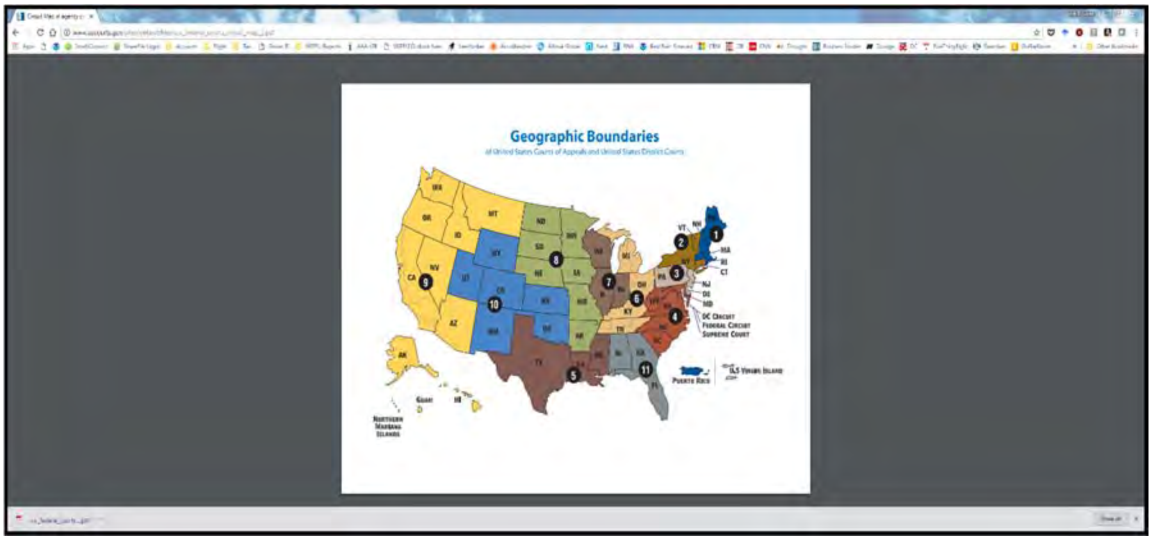
As a result, the Court held that the disregarded single-member LLCs constituted pass-thru partners under §6231(a)(9) and that therefore the small partnership exception did not apply.

The Court also held that AGK, not Kotick, was the tax matters partner.

Based on its conclusion above, the Court said that an entity's disregarded status does not preclude its treatment as a separate, pass-thru partner for the purposes of applying TEFRA's procedures. AGK was the tax matters partner under §6231(a)(7)(B). Because he was not Seaview's tax matters partner, Kotick did not have standing to file the petition.

Summa Holdings, Inc. v. Commissioner, (CA 6 2/16/2017) 119 AFTR 2d ¶2017-447.

The Court of Appeals for the Sixth Circuit, reversing the Tax Court, has upheld the taxpayers' use of a domestic international sales corporation (DISC) to transfer amounts from a C corporation to Roth IRAs of the sons of the C corporation's controlling shareholder, with the result that each IRA exceeded $3 million over a short period of time despite the applicable contribution limits and Roth eligibility requirements. The Appellate Court shed some light on its view of the substance over form doctrine in reaching its conclusion that, while the purpose of the transactions was clearly tax avoidance, the taxpayers' actions were "congressionally sanctioned," making IRS's application of the doctrine inappropriate.


Geographic Boundaries
of United States Courts of Appeals and United States District Courts
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VT
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Federal Circuit
Supreme Court
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A DISC provides a mechanism for deferral of a portion of the Federal income tax on income from exports. The DISC itself is not taxed, but instead the DISC's shareholders are currently taxed on a portion of the DISC's earnings in the form of a deemed distribution. (§991, §995(b)(1)) This allows for deferral of taxation on the remainder of the DISC's earnings. (§995(b)(2), §995(c), §996(a)(1)) A DISC may be no more than a shell corporation which performs no functions other than to receive commissions on foreign sales made by its parent. (*Foley Machinery Co*., (1988) 91 TC 434)

§995(g) provides that when a tax-exempt entity that is a shareholder of a DISC is deemed to receive a distribution from a DISC, actually receives a distribution from a DISC of previously untaxed income, or realizes gain from disposition of DISC shares which is treated as a dividend, that income is treated as derived from the conduct of an unrelated trade or business. For this purpose, a "tax-exempt entity" includes IRAs. §995(g) was enacted to ensure that taxpayers could not shield active business income from tax by assigning DISC stock to controlled tax-exempt entities. (H.R. Rept. No. 101-247 (1989))

Contributions to a Roth IRA are not tax deductible, but all earnings accumulate tax-free, and all qualified distributions are tax-free. (§408A(a), §408A(c)(1), §408A(d)(1)) The Code establishes a maximum aggregate amount that an individual can contribute to all of his Roth IRAs for a tax year. (§408A(c)(2)) §4973(a) imposes for each tax year an excise tax of 6% for excess contributions to a Roth IRA.

Notice 2004-8, 2004-1 CB 333, states that where a taxpayer's preexisting business enters into transactions with a corporation owned by the taxpayer's Roth IRA, in certain cases the transactions are not fairly valued and thus have the effect of shifting value into the Roth IRA. The notice identified three ways in which IRS would attempt to challenge these transactions, one of which was to assert that the substance of the transaction is that the amount of the value shifted from the preexisting business to the corporation is a payment to the taxpayer, followed by a contribution by the taxpayer to the Roth IRA.

Substance over form is a judicial doctrine in which a court looks to the objective economic realities of a transaction rather than to the particular form the parties employed. (*Frank Lyon Co. v. U.S.,* (1978, Sup Ct) 41 AFTR 2d 78-1142) In essence, the formalisms of a transaction, which often exist solely to alter the parties' tax liabilities, are disregarded, and the substance of the transaction is examined in order to determine its true nature. In applying the doctrine, courts may consider whether the form of the transaction had any purpose beyond reducing taxes.

Summa was a C corporation manufacturer that was owned by James Benenson, Jr. (James) and the Benenson Trust. The beneficiaries of the Benenson Trust were James's two sons. James had the power to direct Summa's operations.

In 2001, the sons each established Roth IRAs (the Roth IRAs). The Roth IRAs created JC Export, a DISC, and transferred cash to it in exchange for its stock.

Summa entered into a series of transactions with JC Export which resulted in it transferring several millions of dollars to JC Export. JC Export then paid most of the amount it received in those transactions to the Roth IRAs as dividends.

James did not report any dividend distributions on his tax return. Summa deducted the amount it paid JC Export, and JC Export reported taxable income that was reflective of the amount that it received from Summa.

IRS issued notices of deficiency in which it determined that the payments that Summa made to JC Export were, in substance, dividends to Summa's shareholders followed by contributions by the shareholders to the Roth IRAs.

Summa and James brought suit in Tax Court. The parties stipulated that: a) the taxpayers' sole reason for entering into the transactions at issue was to transfer money into the Roth IRAs so that income on assets could accumulate and be distributed tax-free; and b) the taxpayers had no nontax business purpose for the transactions, nor did they receive any economic benefit from the transactions.

Applying the substance over form doctrine, the Tax Court held that the payments that Summa made to JC Export were not DISC commissions but rather were deemed dividends to Summa's shareholders followed by contributions to the Roth IRAs. (*Summa Holdings Inc.,* TC Memo 2015-119)

IRS argued that the taxpayers shifted value to the Roth IRAs far in excess of the annual contribution limits, and that simply labeling the payments as DISC commissions did not immunize the payments from the application of substance-over-form principles. IRS further noted that the taxpayers had no nontax business purpose for establishing the Roth IRAs or the DISC, and taxpayers did not receive any nontax economic benefits from the transactions at issue. The Court agreed.

The Tax Court also rejected the taxpayers argument that the existence of §995(g) meant that Congress could have prohibited transactions involving DISCs owned by IRAs but chose not to do so and instead allowed IRAs to hold DISC stock. The Court reasoned that the fact that Congress chose to prevent one particular abusive transaction involving DISCs and IRAs does not indicate that Congress approves of all other abusive transactions involving DISCs and IRAs. In addition, as §995(g) was enacted almost 10 years before the Roth IRA provisions, Congress could not have been aware of the type of abusive transaction involving Roth IRAs at issue here at the time of enactment of §995(g).

The Court of Appeals for the Sixth Circuit found that, while the purpose of the transactions was obviously and admittedly to lower taxes, it was expressly authorized under the Code. Therefore, IRS's application of the substance over form doctrine to effectively undo a Code-sanctioned transaction was inappropriate.

The Appellate Court reasoned that DISCs were given a number of tax incentives to encourage companies to export their goods. The Court also noted that Congress has made it clear that corporations and other entities, including IRAs, may own shares in DISCs. (§246(d), §995(g))

Prior to §995(g), there was a "gap" under which tax-exempt entities paid no tax on DISC dividends, which allowed export companies to shield active business income from tax. By enacting §995(g) in 1989, Congress required tax-exempt entities to pay an unrelated business income tax, thus making it less attractive for a traditional IRA to own shares in a DISC.

However, given the way that Roth IRAs are taxed (i.e., contributions are of taxed income but withdrawals are tax-free) and other differences between traditional and Roth IRAs, it was still "attractive" from a tax perspective, during the years at issue in this case, for a Roth IRA to own shares in a DISC. The owner of a closely held export company could transfer money from the company to the DISC and pay some (or all) of that money as a dividend to its shareholders, allowing the money to enter the Roth IRA and grow there. The Roth IRA account holder would have to pay the unrelated business income tax when the DISC dividends go into the account, but they could then be invested freely and grow without further tax consequences. This, in essence, is what occurred in this case.

The Court found it telling that both sides agreed that transactions in this case complied with the Code. It found that the substance over form doctrine allows IRS to "recharacterize the economic substance of the transaction" and "honor the fiscal realities of what taxpayers have done over the form in which they have done it," but that it does not allow IRS to "recharacterize the meaning of statutes." The Court stated that DISCs are, by congressional design, "all form and no substance," and that application of the substance over form doctrine thus does not apply here.

In addition, the Court noted that Roth IRAs are also designed for tax reduction purposes. While the taxpayers in this case structured the transactions to lower their taxes, they did so in a way that both had economic substance and was sanctioned by the Code, and the mere existence of a higher-tax alternative does not give IRS the right to assert that the higher-tax route is the "real" transaction.

Overall, the Court found that the substance over form doctrine makes sense only when the taxpayer's formal characterization of a transaction fails to capture economic reality and would distort the meaning of the Code in the process. The transaction in this case was tax-advantaged but complied with the Code. While the tax benefits might have been unintended, it was a "text-driven consequence."

Observation: See Rev. Rul. 81-54 where the IRS held that when individual shareholders of a DISC transferred their shares in the DISC to their minor children, both the stock transfers themselves and the subsequent commission payments to the DISC constituted gifts. The IRS continues to hold this view as evidenced in PLR 201341023.

Observation: Ownership of IC-DISC stock in different proportions than exporting company stock can remove IC-DISC dividends from an estate. Rev. Rul. 81-54 may result in gift tax exposure, but Hellweg decision (T.C. Memo 2011-58) effectively held Rev. Rul. 81-54 inapplicable. In 2011, the Tax Court ruled in the taxpayers' favor in a case involving a DISC indirectly owned by Roth IRAs when the IRS sought to impose excise taxes and penalties on the taxpayers

Transupport Inc., TC Memo 2016-216.

The Tax Court has sustained IRS's adjustments to a closely-held C corporation's deductions for compensation of the controlling shareholder's sons and for cost of goods sold (COGS). It also criticized both the taxpayer's and IRS's expert witnesses who testified with respect to those deductions.

IRS had tried to impose over $22 million of additional tax and fraud penalties on the taxpayer, but the Tax Court in *Transport, Incorporation*, T.C. Memo 2015-179, held that seven of the ten years on which tax was imposed were closed because fraud was not established.

For compensation paid by an employer to be deductible under §162, the amount must be reasonable, and the payment must be purely for services rendered.

Courts have considered various factors in assessing the reasonableness of compensation, such as: employee qualifications; the nature, extent, and scope of the employee's work; the shareholder-employees' compensation compared with that paid to non-shareholder-employees; prevailing rates of compensation for comparable positions in comparable concerns; and comparison of compensation paid to a particular shareholder-employee in previous years where the corporation has a limited number of officers. No single factor is dispositive. Special scrutiny is given in situations where a corporation is controlled by the employees to whom the compensation is paid because there is a lack of arm's-length bargaining. (*Charles Schneider & Co.,* (CA 8 1974) 34 AFTR 2d 74-5422)

The taxpayer, Transupport Inc., was in two related businesses. First, it was a supplier and surplus dealer of aircraft engines and engine parts for use in military vehicles. For this business, it primarily purchased surplus parts from the Government in bulk lots that contained parts having little value as well as parts that Transupport wanted for its business. The costs of particular items were not specified as part of the purchase transactions.

Transupport was also a distributor of parts. The purchased distributorship items were susceptible of accurate inventory accounting, and some computer records were kept in later years; but an accurate inventory was never made part of Transupport's financial and tax reporting.

Transupport was not a manufacturer.

Harold Foote (Foote), its president and chief executive officer, founded Transupport. During the years in issue, Foote and his four sons, William Foote (W. Foote), Kenneth Foote (K. Foote), Richard Foote (R. Foote), and Jeffrey Foote (J. Foote) were Transupport's only full-time employees and officers. Each of the officers performed various and overlapping tasks for the company, including tasks that might have been performed by lower-level employees. The officers performed no supervisory functions.

Transupport provided to the Thompson accounting firm handwritten summaries, usually prepared by J. Foote. Elaine Thompson, through her accounting firm, prepared compiled financial statements for Transupport for 1990 through 2008 that were based upon the summaries. The financial statements were not audited by Thompson or her firm, and the information on the summaries was never verified by Thompson or her firm.

Transupport filed Form 1120, U.S. Corporation Income Tax Return, for each of the years in issue, 2006-2008. Thompson prepared Transupport's Forms 1120 using the same financial information that Transupport provided in connection with preparation of Transupport's compiled financial statements.

Transupport did not maintain a physical inventory of the unsold parts in its warehouse and backed into the closing inventory, reported in its returns, by using a percentage of sales as costs of goods sold. That percentage was derived "on the basis of Foote's experience" and was approximately 30%.

Foote alone determined the compensation payable to his sons. He did not consult his accountant or anyone else in determining their compensation. The only apparent factors considered in determining annual compensation were reduction of his reported taxable income and equal treatment of each son. For the years at issue, Foote's compensation was $353,000, $479,000 and $600,000, and each of the sons received $575,000, $675,000 and $720,000.

The only dividend Transupport reported paid over the 10-year period ending with 2008 was $47,759 for 2003, in the form of unrealized cash surrender value of life insurance. No dividends were paid during 2006, 2007, or 2008.

In 2007, Foote considered selling Transupport. He entered into a contract with a business broker who put together a "Confidential Offering Memorandum," which included a "Recast Financial Summary" in which the profits of Transupport's operations as reported on its financial statements and tax returns were substantially increased. Explanatory notes on the Recast Financial Summary included: "Five shareholder salaries recast to market rate of $50,000 annually each. Management has elected to use an accounting method that writes off the majority of inventory as purchased. It is conservatively estimated that actual gross profit on sales exceeds 75% on general part sales and 33% on distributor sales."

W. Foote prepared a list of some of the inventory for the broker and priced that inventory based on a standard pricing guide. The value of inventory on this partial list far exceeded the inventory values reported on Transupport's relevant financial statements and tax return.

During his conversations with prospective purchasers, Foote never disavowed the information set forth in the broker documents.

IRS auditor Canale and appraiser/valuation specialist Wojick audited Transupport's 2006-2008 returns. Neither Canale nor Wojick attempted to conduct an inventory valuation of the parts in Transupport's warehouse.

Wojick prepared a reasonable compensation analysis that was used in preparation of the notices of deficiency. He had done some reasonable compensation studies previously but had never testified as a reasonable compensation expert in court. He consulted a database from the Economic Research Institute. He also reviewed Transupport's 2006 tax return, a general description of its business, and resumes of its officers. He did not, however, interview the Footes with regard to their duties performed for Transupport.

The category that Wojick used in the database was aircraft parts manufacturers. He did not realize that the "aircraft parts manufacturers" category did not include wholesalers, such as Transupport. Wojick also used a database for executives' compensation rather than a broader salary base. His calculation reduced Foote's compensation by $340,000 for the three years and each of the sons' compensation by $820,000 for the three years.

The notices of deficiency also adjusted Transupport's costs of goods sold to reflect a 75% profit on Transupport's sales of surplus parts.

The Tax Court accepted IRS's calculation of reasonable compensation that was used in its notices of deficiency.

It noted the testimony of each of the Foote sons in which each denied knowledge of principles basic to the performance of his respective functions on behalf of Transupport. K. Foote worked closely with purchases and sales but had "no clue" as to how much the inventory was worth and did not know how costs of goods sold were determined. J. Foote, who acted as Transupport's chief financial officer, testified that he had "no idea" or "not a clue" about Transupport's inventory at cost in 2007. J. Foote provided to Transupport's accountant the numbers used in preparing Transupport's tax returns, but he had no idea whether the amounts reported on the returns were correct. W. Foote, whose duties included inventory management, asserted that "nobody understands...our inventory" and that nobody can put a total valuation on it. As to a specific part in the inventory, he had "no earthly clue" as to the purchase price.

None of the Foote sons had special experience or educational background. Each of the four sons testified that they had overlapping duties and that those duties included menial tasks because there were no other employees. Foote testified that he intended to treat his sons equally, that he alone determined their compensation, and that he was aware of their marginal tax rates, obviously intending to minimize Transupport's tax liability. The Court said that the amounts and equivalency of the brothers' compensation, the disproportionality to Foote's compensation, the manner in which Foote alone dictated the amounts, the reduction of reported taxable income to minimal amounts, and the admissions in the broker materials relating to their compensation all justified skepticism toward Transupport's assertions that the amounts claimed on the returns were reasonable.

The Court concluded that Transupport's expert, Mr. Kirkland, disregarded objective and relevant facts and did not reach independent judgments. Among the Court's objections were: a) he did not consider or adjust for any of the foregoing factors; b) he disregarded sources and criteria that he used in other cases and that would have resulted in lower indicated reasonable compensation amounts; c) he placed Transupport's officers in the 90th percentile of persons in allegedly comparable positions, which their own testimony showed that they were not; d) he determined aggregate compensation of the top five senior executives in companies included in his single database while acknowledging that the titles assigned and duties performed by Transupport's officers, as they themselves indicated during his interviews of them, were not typical of persons holding senior executive offices; and e) his report discussed officer retainment as a reason for high compensation, but he did not consider the unlikelihood-as confirmed by the Footes' testimony-that any of the sons would ever leave Transupport's employ, even if he were paid less.

In Court, IRS relied on the calculations of Mr. Scheig, a qualified compensation expert, rather than those of Wojick. Scheig concluded that the notices of deficiency allowed too much compensation to be deductible.

Transupport argued that this "switch from the amounts in the notices" justified switching the burden of proof to IRS on the compensation issue. Transupport cited *Estate of Abraham,* (CA 1 2005), 95 AFTR 2d 2005-2591, for what the Court called "the undisputed proposition" that IRS bears the burden of proof on a new matter. In that case, however, the Court of Appeals observed that a theory that merely clarifies or develops the original determination is not a new matter. The Court here said that the same could be said here.

Transupport also contended that IRS's change showed that the original determination was arbitrary. But the Court said that Transupport had advance notice of IRS's positions and conducted extensive depositions. There was no surprise at trial and no unfairness in IRS's more fully supported and justified recomputation of Transupport's deductions for compensation to the Foote sons. No different evidence on Transupport's part was required because Transupport always had the burden of proving its deductible compensation, and that burden would not be satisfied by cross-examination of IRS's expert. If IRS had not presented any expert on compensation, Transupport would still be required to justify the amounts claimed on the returns, and none of the evidence did that.

The Court accepted Wojick's, not Scheig's calculations, noting that Scheig did not question Foote's compensation, and accepting that Foote's compensation was correct, Scheig's calculation left each of the sons' reasonable compensation at an annual average of around $100,000, with the actual amounts for the sons decreasing each year. The Court made a particular point of Scheig not defending those compensation amounts decreasing each year.

The Court also held that the taxpayer did not meet its burden of proving IRS's determination of COGS was wrong, and thus the Court agreed with that determination.

The Court said that the approach of Transupport's expert, a Thompson accounting firm accountant, to the accounting for COGS was that the consistent pattern over the years 1999-2008 was "self-proving." The accountant relied solely on percentages reported on Transupport's self-generated documents over 19 years as proof of profit percentages, but no historic evidence of actual percentages realized was ever produced. In other words, Transupport asserted that the percentage of gross profit reported was evidence of the percentage of gross profit realized-circular reasoning that ignored the evidence that the percentage of reported gross profits actually varied, that the financial statements were unreliable because of the greatly understated inventories at the beginning and end of each year, and that (according to Foote and confirmed by the correlation between purchases and reported costs of goods sold) current purchases were written off during the years without regard to whether the items were added to the inventory or sold.

Tseytin v. Commissioner, (CA 3 08/18/2017) 120 AFTR 2d ¶2017-5160.

The Court of Appeals for the Third Circuit has affirmed a Tax Court decision that a primary shareholder of a company who bought out the minority shareholder and sold all of the company shares should be taxed on the gain attributable to all of the shares, including those purchased from the minority shareholder. The Court rejected the taxpayer's claim that he merely acted an agent for the minority shareholder, finding that this claim was undermined by the relevant agreements and overall facts of the case. The Third Circuit also rejected the taxpayer's argument that he should be permitted to recognize losses on the sale of the shares originally belonging to the minority shareholder, finding that §356(c) mandated nonrecognition of losses in this case.

Under §354, no gain or loss will be recognized if stock or securities in a corporation that is a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation that is a party to the reorganization. However, if the nonrecognition rules of §354 would apply to an exchange but for the fact that property other than stock or securities (i.e., boot) is also received in the exchange, gain is recognized, but only up to the sum of the money received and the fair market value of the other property. (§356(a)(1), Regulation §1.356-1(a)(1)) No loss is recognized on the exchange or distribution if the nonrecognition rules of §354 or §355 would apply to an exchange or distribution but for the fact that property other than stock or securities is also received in the exchange. (§356(c))

As described by the Third Circuit, IRS "analyzes multifaceted transactions according to their separate units, so that a taxpayer may not end-run the no-recognition-of-losses rule by tucking one unit's unrecognizable loss under the transaction's broader recognizable gain." For example, in *Lakeside Irrigation Co. v. Commissioner,* (CA 5 1942) 29 AFTR 521, an irrigation company sold four blocks of stock in return for certain business debts being forgiven. The company realized gains on two of the blocks of stock, losses on the other two, and an overall gain when all of the gains and losses on the four blocks were netted. This sale "raised the specter of a statute similar to" §356(c) that would require recognition of the gains while prohibiting recognition of the losses. The company attempted to avoid the non-recognition problem by characterizing the 4-block transfer as one big exchange, allowing the company to subtract the 2-block loss from the larger 2-block gain and report to IRS one smaller gain. This arrangement was ultimately found by the Fifth Circuit to be impermissible because when a transaction involves separate units, each must be analyzed separately. (*Lakeside Irrigation Co*.)

US Strategies, Inc. (USSI), a domestic corporation, owned a majority (91%) interest in two Russian limited liability companies that owned and operated most of Russian's Pizza Hut and Kentucky Fried

Chicken franchises. Shares of USSI were 75% owned by Michael Tseytin and 25% owned by Archer Consulting Corporation (Archer). Tseytin had zero basis in his shares.

In May of 2007, USSI, Mr. Tseytin, and AmRest Holdings, NV (AmRest), a Netherlands corporation also involved in the fast-food business, agreed to the merger of USSI into AmRest. The merger was to qualify as a tax-free reorganization under §356 and §368(a). In order to effect the transfer and merger, Mr. Tseytin agreed to purchase Archer's shares (the Archer shares) for $14 million and then transfer to AmRest 100% of the shares of stock in USSI. In exchange for transferring all of the USSI stock to AmRest, Mr. Tseytin was to receive as consideration approximately $23 million in cash and AmRest stock equal to approximately $31 million. Archer was not a party to the AmRest agreement.

On May 25, 2007, Mr. Tseytin entered into a securities purchase agreement with Archer under which he agreed to purchase the Archer shares for $14 million. Under the agreement, he was to receive "all right, title and interest in and to the Archer shares, free and clear of all liens, claims and other encumbrances," and he agreed to purchase the Archer shares for his "own account." AmRest was not a party to the Archer agreement.

In further preparation for the USSI-AmRest merger, Mr. Tseytin took a number of actions as sole shareholder of USSI, including amending its bylaws, appointing himself its sole director, and giving shareholder approval for the merger. On July 2, 2007, the merger between USSI and AmRest closed, and Mr. Tseytin received $23 million in cash and $31 million worth of AmRest stock. On July 5, Mr. Tseytin paid Archer $14 million.

On his 2007 Form 1040, Mr. Tseytin treated the USSI stock involved in the merger as one block of stock, all owned and transferred by him to AmRest, and reported and paid a $3.8 million tax liability. He subsequently filed an amended return in 2009 that, in effect, treated the stock as two "blocks" (the Archer shares and those owned by him) and reflected the position that he should be allowed to reduce his proceeds from the transaction by the $14 million that he paid to Archer, reasoning that he was merely acting as an agent. His 2009 amended return reported a $2.6 million liability, and he sought a refund of the difference, which IRS denied.

Mr. Tseytin argued that, in transferring the Archer shares to AmRest, he acted only as a nominee or agent for Archer, that he never owned the Archer shares, and that the Court should treat the Archer shares as either (i) sold directly by Archer to AmRest, or (ii) redeemed by USSI or by AmRest from Archer. IRS disagreed.

In the alternative, he argued that if he were to be treated as owner of the Archer shares on their transfer to AmRest, he should be allowed to subtract losses on the sale of the Archer shares ($13.5 million [$54 million total consideration × 25% allocable to Archer shares] − $14 million purchase price = $500,000 loss). IRS, however, claimed that the $500,000 loss was disallowed under §354(a) and §356.

The Tax Court held that Mr. Tseytin was bound by the form of the transactions he entered into and so was to be treated as the recipient of the portion of the cash boot received in the merger that was allocable to the Archer shares. There was no persuasive evidence that would support a finding of a nominee or agency relationship between Mr. Tseytin and Archer or that the Archer shares of stock in USSI were redeemed from Archer by USSI or by AmRest. Nor was there any argument that there was any mistake, fraud, undue influence, duress, or the like, that might support a recharacterization of the transaction.

The Tax Court also concluded that Mr. Tseytin could not net his $500,000 realized loss on the Archer shares against his recognized long-term gains, finding that Mr. Tseytin failed to cite any authority as support for doing so. Additionally, the Tax Court sustained IRS's imposition of an accuracy-related penalty.

The Court of Appeals for the Third Circuit largely affirmed the Tax Court's decision (remanding only for the limited purpose of addressing the liability of Mr. Tseytin's wife for his unpaid taxes).

First, the Third Circuit found that the form of the transaction with AmRest controlled and that Mr. Tseytin was liable for tax on the full amount that he received for the shares, including the $14 million that was remitted to Archer. The underlying agreements made it clear that he purchased the stock and was its owner, and that no agency relationship was created between Archer and Tseytin. Although he perhaps could have structured the deal to avoid acquiring formal ownership of the shares, he did not do so and was stuck with the tax consequences of the deal he made.

The Third Circuit also rejected Mr. Tseytin's alternative argument that he should be allowed to subtract his purported losses from the sale of the Archer shares from his overall gains from the transaction. The Court concluded that the blocks of stock were separate units that must be treated as such, citing *Lakeside Irrigation Co*. Notably, the "blocks" were acquired at different times and Mr. Tseytin had "a vastly different basis" in the two blocks. Accordingly, §356 clearly prohibited recognition of any loss from the Archer stock.

Tucker v. Commissioner, (CA 11 11/21/2016) 118 AFTR 2d ¶2016-5521.

The Court of Appeals for the Eleventh Circuit, affirming the Tax Court, has upheld IRS's disallowance of net operating loss (NOL) carrybacks claimed by the sole shareholder of an S corporation in respect to real estate that he said was either abandoned or rendered worthless by the 2008 housing crisis. The Appellate Court found that the S Corporation’s actions regarding the properties, which included both sales and development activities undertaken after 2008, belied his claims of worthlessness or abandonment.

§165(a) allows a deduction for any loss sustained during the tax year and not compensated for by insurance or otherwise. In order for the loss to be deductible, it must be "evidenced by closed and completed transactions, fixed by identifiable events, and...actually sustained during the taxable year." (Regulation §1.165-1(b)) In most cases, a "closed and completed transaction" will occur upon a sale or other disposition of property, but in some cases, this requirement may be satisfied if the taxpayer abandons an asset or the asset becomes worthless. (*Proesel,* (1981) 77 TC 992)

A §165 loss for abandonment requires both an intent to abandon the asset and an affirmative act of abandonment. (*Citron,* (1991) 97 TC 200) Mere non-use is not sufficient. (*Zurn,* TC Memo 1996-386)

A §165 loss for worthlessness of mortgaged property requires worthlessness of the taxpayer's equity in the property. (*Commissioner v. Abramson*, (CA 2 1942) 28 AFTR 779) When a taxpayer's real property is secured by a recourse obligation, the taxpayer is not entitled to a loss deduction until the year of the foreclosure sale, regardless of whether the taxpayer claims to have abandoned the property in a prior year or claims the property became worthless in a prior year. (*Helvering v. Hammel,* (Sup Ct 1941) 24 AFTR 1082)

Harvey Tucker was the president, director, and sole shareholder of an S corporation called Paragon Homes Corporation (Paragon), which was in the business of real estate acquisition, development, and sales. Paragon was incorporated in 1997 and remained an active corporation until September 28, 2012. Paragon owned several residential real estate properties that were subject to mortgage loans, all of which were personally guaranteed by Tucker. At the beginning of 2008, Paragon was a solvent company meeting its payroll and paying its mortgage obligations, rent, insurance premiums, real estate taxes, and utility bills.

In 2007 and 2008, the residential real estate market went into sharp decline. According to Tucker, Paragon was out of business and insolvent by the end of 2008, and he considered Paragon's real estate inventory worthless as of December 31, 2008.

Even after Paragon was allegedly shuttered at the end of 2008, Tucker was aware of his continuing obligations on the mortgages. He claimed that, at the end of 2008, he owed more than $2 million on Paragon's underwater properties. In the summer of 2009, Tucker transferred over $1.3 million to Paragon, which he testified was in order to discharge his liabilities and "protect" himself.

Over the next few years, the mortgage companies filed foreclosure suits against Tucker and Paragon. Some of the suits were settled, and Tucker claimed that the settlement proceeds came from him; and some of the properties were sold, satisfying their mortgage obligations. None were actually foreclosed. During that same time, Paragon also sold a couple of properties and undertook construction on others. On November 30, 2009, there was a balance of $839,745 in Paragon's bank account.

On its 2008 federal income tax return, Paragon reported a loss of approximately $10.8 million, $8.9 million of which was attributable to a "write down" of its real estate inventory to current market value as of December 31, 2008. Tucker then claimed a flow-through loss from Paragon of roughly $6.8 million on his individual 2008 income tax return. As a result of this loss, Tucker reported a 2008 NOL of more than $6.7 million, which he elected to carry back to tax years 2003, 2004, 2005, 2006, and 2007. Tucker sought a refund totaling almost $2 million based on the loss carrybacks.

IRS conducted an audit and concluded that Paragon's allowable loss for 2008 was actually only $1.5 million. A deficiency notice was issued to Tucker, disallowing his claimed NOL carrybacks for 2004, 2005, and 2006 and showing deficiencies and accuracy-related penalties for those years. Tucker filed a petition in the Tax Court.

The Tax Court largely upheld IRS's determination, finding no indication that the properties were actually abandoned by the end of 2008. (*Tucker,* TC Memo 2015-185) Tucker appealed.

The Court of Appeals for the Eleventh Circuit affirmed the Tax Court's decision, concluding that the record demonstrates that Paragon continued to develop and sell the properties throughout 2009 and 2010. Tucker also funneled more than $800,000 of his personal money into Paragon's business account in order to facilitate construction on the properties. The Court also found it telling that Paragon settled a number of the foreclosure suits rather than re-conveying the properties to the lenders, which was inconsistent with any claims of abandonment.

The Court said that, while Tucker claimed that he took these actions only to protect himself (vs. Paragon), he failed to show that this subjective intent was sufficient to show abandonment. And, his argument that Paragon was essentially defunct and out of business by the end of 2008 was belied by evidence demonstrating that it continued to do business well after that time.

The Eleventh Circuit also found that the properties were not worthless as of the end of 2008. It found Tucker's attempt to avoid the general rule for property subject to recourse debts (i.e., no loss deduction until the year that a foreclosure sale occurs) to be strained and unsupported. Tucker generally claimed that the "closed and completed transaction" requirement was met in this case because the 2008 housing crisis was a fixed event and that, at that time, there was no reasonable prospect that Paragon would make further payments with respect to the properties. However, the Court found that, in addition to being strained, this argument was undercut by the facts that Paragon remained operational after it supposedly went out of business.

Washington Mutual, Inc. v. U.S., (CA 9 5/12/2017) 119 AFTR 2d ¶ 2017-757.

The Court of Appeals for the Ninth Circuit, affirming a district court, has concluded in a refund suit that a bank failed to establish a reliable cost basis in certain rights it obtained in connection with its acquisition of certain failed savings and loan associations (S&Ls) during the 1970s and 1980s. Accordingly, its amortization deductions were not allowed. The Court also found that the bank was not entitled to take an abandonment loss.

Most items of tangible property and certain intangibles are depreciable/amortizable if they: (1) are used in a trade or business, or held for the production of income; (2) have an exhaustible useful life that can be determined with reasonable accuracy; and (3) are not inventory or stock in trade. (§167; Regulation §1.167(a)-1) Depreciation deductions under §167 are generally allowed for a tax year as a percentage of the depreciable basis of the property, which is generally the adjusted basis of the property used to determine gain or loss on a sale or other disposition. (§167(c)(1)) Adjusted basis is generally basis determined under §1012 -i.e., the property's cost-with certain adjustments.

A loss incurred because of the abandonment of worthless property is generally deductible under §165(a) if the loss is incurred in a business or in a transaction entered into for profit. For the deduction to be allowable for a tax year, two conditions must be satisfied in that year: (1) the property becomes entirely worthless, and (2) the taxpayer shows an intent to abandon it coupled with overt acts of abandonment. The loss cannot exceed the adjusted basis of the property for determining loss on a disposition. (Regulation §1.165-1(c))

In the late 1970s and early 1980s, high interest rates and inflation left many thrifts in distress. The liabilities of the numerous already-failed thrifts threatened to exhaust the insurance reserves of the Federal Savings and Loan Insurance Corporation (FSLIC). To limit its insurance liability, the Federal Home Loan Bank Board (Bank Board) induced healthy financial institutions to take over troubled thrifts in "supervisory mergers." The principal inducement was that such acquisitions would be subject under the Federal Home Loan Bank Board (FHLBB) rules to a particular accounting method (the purchase method), which focused on Regulatory Accounting Principles (RAP rights), under which the acquiring entity would be allowed to designate the excess of the purchase price over the fair value of all identifiable assets acquired as an intangible asset-supervisory goodwill.

In a supervisory merger undertaken as part of the Bank Board's strategy to mitigate the S&L crisis, Home Savings of America, FSB (Home) acquired three failing thrifts. Through a series of transactions, Home assumed the liabilities of the failing thrifts in exchange for a generous incentive package under which Home received, among other things, cash and indemnities as to covered assets, and was allowed to structure the transaction as a tax-free Type "G" reorganization, giving it significant tax benefits. Home also received Branching rights for Missouri and Florida, allowing it to open branches in those states, as well as the RAP right and its associated benefits.

Home sold its Missouri branch offices in 1992 and 1993 and was later acquired by Washington Mutual, Inc. (Washington Mutual) in 1998. In 2005, Washington Mutual, filed amended tax returns on behalf of Home, requesting refunds for tax years 1990, 1992, and 1993. For those tax years, IRS had denied Home amortization deductions for its RAP right and had refused to allowed an abandonment loss deduction in 1993 for the Missouri Branching right. IRS denied the claims, and Washington Mutual sued in district court.

The district court ruled in favor of IRS, deciding that Home did not have a cost basis in either the RAP right or the Branching right. The district court was also not convinced that Home had permanently abandoned its right to operate in Missouri and so entitled to take an abandonment loss. Accordingly, the court denied Washington Mutual a refund based on the claimed amortization and loss deductions.

On appeal of the district court's decision, the Ninth Circuit held that Home Savings had a cost basis in both sets of rights equal to some part of the excess of the acquired thrifts' liabilities over the value of their assets, and remanded for determination of that cost basis.

On remand, the district court determined that Washington Mutual had not met its burden of proving Home Savings's cost basis in the rights at issue. The court also found that Home had not shown that it had permanently abandoned its right to operate in Missouri, and so it was not entitled to take an abandonment loss for the 1993 tax year.

The district court reasoned that the taxpayer was required to do two things to establish the cost basis for each right: (1) it needed to establish the purchase price for the failed thrifts (which could be determined by subtracting the value of the three failed thrifts' assets from their liabilities); and (2) it needed to show what portion of that purchase price should be allocated among the various rights. Because the purchase price was less than the total fair market value (FMV) of Home's incentive package, it was not enough for the taxpayer to determine the FMV of a single asset and assign to it a proportionate amount of the purchase price. Rather, the taxpayer had to establish the FMV of each individual asset to reach a total FMV for the entire incentive package. The taxpayer could then use this total FMV to determine each asset's proportionate value, and apply that value pro rata to the purchase price to establish the cost basis of each asset.

The district court found that the taxpayer failed to establish, to a reasonable certainty, the FMV for the Missouri Branching Right and so could not establish a cost basis in that right or in the RAP right. The taxpayer failed to meet its evidentiary burden in large part due to shortcomings in the testimony of its expert, whose valuation model was found to be fundamentally flawed and unreliable as a basis for determining the value of the Missouri Branching right.

For example, the court determined that the assumptions regarding Missouri deposit market growth were unreliable because the projections for statewide deposit growth failed to account for the effects of disintermediation (i.e., the withdrawal of deposit accounts from the thrift industry) and improperly included interest credited balances (i.e., interest posted to the accounts of existing customers) as a source of "new" deposit growth, thereby inflating the calculations. The court also faulted the expert's assumption that Home's ability to capture market share in Missouri could be adequately predicted by looking to its prior expansion into Northern California. Further, the court found that evidence presented at trial did not support the model's underlying assumption that a hypothetical buyer could originate a sufficiently high volume of new loans to offset the costs of all projected new deposits in the market at that time. And, the district court rejected as "unrealistic" the model's assumption that a hypothetical buyer could count on a net interest spread of 2.5% between its income-generating loans and its outgoing deposit payments.

In addition, the district court held that Home had not abandoned the Missouri Branching right in 1993 and was therefore not entitled to an abandonment loss deduction for that tax year. While the taxpayer showed that Home had entered into three agreements to either sell or exchange the Missouri branches, and that each agreement contained a covenant not to compete-prohibiting Home from soliciting deposits for a limited period (two or three years) in the designated geographic area-the district court focused on the fact that the non-compete clauses contained exceptions that reserved for Home the right to re-enter the market. Further, testimony of Home's executives indicated that Home had not foreclosed the option of using the Missouri Branching right in the future.

The Ninth Circuit held that the district court permissibly concluded that the taxpayer did not meet its burden of establishing a cost basis for its intangible assets. The Court found that the district court applied the proper legal standards, did not clearly err in determining that the evidence was insufficient to reliably value the Missouri Branching right, and was not required to on its own assign a value to that right. The Court also held that the taxpayer had failed to establish that Home had permanently abandoned its right to operate in Missouri for purposes of an abandonment loss deduction.

The Court rejected the taxpayer's contention that the district court improperly held the taxpayer to an unwarranted standard and required it to establish the market value of the Missouri Branching right under a heightened level of "certainty" and "precision," instead of simply requiring only a reasonable estimation of its value. The district court properly noted that the burden was on the taxpayer to prove its refund entitlement and that the case law at times used the phrase "exact amount" in describing the amount to be recovered by a taxpayer (see *Compton v. U.S.,* (CA 4 1964) 14 AFTR 2d 5217). But contrary to the taxpayer's argument, the Court found that the district court made clear that the burden was on the taxpayer to only prove its refund entitlement with reasonable specificity; in context, it was clear the reference to proving the "exact amount" was not to be taken literally. Similarly, the district court's observation that the taxpayer bore a "heavy burden" in showing that an intangible asset was capable of separate valuation was merely explaining the difficulties that may confront some taxpayers who were simply unable to show that their assets were capable of individual valuation.

The Court found that none of the district court's challenged factual findings with regard to the expert's valuation model were clearly erroneous, rejecting the taxpayers’ contention that the district court had misunderstood a number of complex and technical issues:

a. The taxpayer argued that the district court's "pessimistic perspective" was incompatible with the perspective of a "willing buyer." However, the Ninth Circuit concluded that the district court realistically assessed market projections at the time of the S&L crisis while the taxpayer's expert and the optimistic assumptions of his model seemed to contravene the economic realities at the time and were also contrary to Home's own 1981 market projections.

b. The taxpayer claimed that the district court erroneously concluded that disintermediation would have reduced both the Missouri deposit market as a whole and the hypothetical buyer's proportional share of that shrinking market. But that was not the only reason the district court rejected the taxpayer's attempt to use Home's Northern California expansion as a predictor of its anticipated results in Missouri. The court determined that predicting future success of an interstate merger at a time when the thrift industry was insolvent by reference to Home's prior ability to capture intrastate market share in a growing market during a relatively stable period was unreliable. The court also noted that this comparison was especially problematic because Home's growth into Northern California was based on acquiring existing institutions, which it did not have in Missouri, and because Home's own projections with regard to Missouri market share were much more conservative.

c. The Ninth Circuit concluded that the district court's conclusion that taxpayer's expert overstated potential statewide deposit growth was also permissible. As the district court noted, the expert included "interest credited" as a source of "new deposit growth." The Ninth Circuit found that the district court correctly faulted the expert's model for including these funds and artificially skewing Missouri's deposit market growth.

d. Nor did the district court clearly err when it rejected the projected 2.5% net interest spread, which the taxpayer's expert claimed a hypothetical buyer could expect to achieve in Missouri. The taxpayer took the position that the district court should have deferred to that projection because it mirrored Home's actual forecasts at the time of the underlying transactions, but nothing in the record or the case law supported the conclusion that the district court was bound by Home's estimates.

In addition, the Ninth Circuit concluded that the district court properly determined that the Missouri Branching right remained potentially useful to Home's ongoing national business to the extent Home could either decide to re-enter the Missouri market or attempt to entice a merger with or a sale to another thrift with similar inclinations to expand outside of its home state. The record clearly allowed this finding, and the court's broad view of Home's business was not clearly erroneous. The Ninth Circuit further concluded that the district court attached the proper significance to the covenants not to compete and to the testimony of Home's executives that Home had not permanently given up on the idea of operating deposit institutions in Missouri.

And finally, the Ninth Circuit rejected the taxpayers' argument that the district court was required to estimate some value for the rights at issue on its own. Such a proposition would essentially do away with the taxpayer's burden. Instead, the cases make clear that a district court may only be obligated to value an asset when it determines that the asset "may be valued separately" or has "a reasonably ascertainable value," or "sufficient evidence was introduced to allow the district court to reach a reasonable conclusion" as to value. (*Capital Blue Cross and Subsidiaries v. Commissioner,* (CA 3 2005) 96 AFTR 2d 2005-7247) Since the district court permissibly determined that the Missouri Branching right did not have a "reasonably ascertainable value," it was not required to undertake such an exercise.

Washington Mutual, Inc. v. U.S., (Ct Fed Cl 2/21/2017) 119 AFTR 2d ¶2017-458.

The Court of Federal Claims has dismissed a bank's suit seeking a refund of taxes paid by its predecessor in interest in respect to a subsidiary. The bank claimed that the subsidiary was entitled to nearly $390 million in deductions with respect to certain intangible assets that were acquired as part of the governmental bailout of savings and loan (S&L) institutions, but the Court found that the bank failed to establish its basis in the assets and thus was not entitled to claim deductions for them.

A loss incurred because of the abandonment of worthless property is generally deductible under §165(a) if the loss is incurred in a business or in a transaction entered into for profit. For the deduction to be allowable for a tax year, two conditions must be satisfied in that year: (1) the property becomes entirely worthless, and (2) the taxpayer shows intent to abandon it coupled with overt acts of abandonment. The loss cannot exceed the adjusted basis of the property for determining loss on a disposition. (Regulation §1.165-1(c))

Most items of tangible property and certain intangibles are depreciable/amortizable if they: (1) are used in a trade or business, or held for the production of income; (2) have an exhaustible useful life that can be determined with reasonable accuracy; and (3) are not inventory or stock in trade. (§167; Regulation §1.167(a)-1) Depreciation deductions under §167 are generally allowed for a tax year as a percentage of the depreciable basis of the property, which is generally the adjusted basis of the property used to determine gain or loss on a sale or other disposition. (§167(c)(1)) Adjusted basis is generally basis determined under §1012 -i.e., the property's cost- with certain adjustments.

A tax refund suit cannot be brought unless the taxpayer first files a timely refund claim with IRS. (§7422(a)) In a de novo tax refund case, taxpayers have the burden of proving, by a preponderance of the evidence, that they are entitled to the tax deductions at issue and the correct amount of the tax refund due. (*U.S. v. Janis,* (S Ct 1976) 38 AFTR 2d 76-5378) In the instant case, to establish the amount of refund due, the taxpayers had to establish an entity's cost basis in certain intangible assets to a "reasonable degree of certainty," which required them to put forward sufficient evidence for the Court to make a "reasonable or rational approximation" of the value of these assets. (*Union Pac. R.R. v. U.S.,* (Ct. Cl 1975) 36 AFTR 2d 75-6251)

Washington Mutual (WaMu) is a successor in interest to H.F. Ahmanson & Co. (Ahmanson), which was the parent company of an affiliated group of corporations including Home Savings of America (Home).

Home was one of the largest savings and loan institutions (or "thrifts") in the U.S. In the early 1980s, Home engaged in four mergers to acquire several failing thrifts with the assistance of the Federal Savings and Loan Insurance Corporation (FSLIC). These transactions were part of the government's response to the savings and loan crisis at that time-"healthy" institutions, like Home, would acquire one or more failing thrifts in exchange for certain incentives and assistance from the FSLIC. In 1988, Home acquired Bowery Savings Bank through a merger with the assistance of the Federal Deposit Insurance Corporation (FDIC). WaMu alleged that Home acquired several intangible assets through the government assistance provided in these mergers, including the right to open branches in the states in which the acquired failing thrifts were located and the contractual approval to treat goodwill created by the transactions as an asset for regulatory accounting purposes (branching rights and RAP rights, respectively).

WaMu asserted that Home obtained a cost basis in the intangible assets acquired through these mergers, including the branching rights and the RAP rights, under §1012. WaMu alleged that Home later abandoned the branching rights with respect to certain states and was thus entitled to take an abandonment loss deduction in the amount of Home's cost basis in these rights under §165. In addition, WaMu claimed that Home was also entitled to take certain amortization deductions for a portion of its cost basis in the RAP right acquired in each of the mergers and in certain other intangible assets pursuant to §167(a).

WaMu claimed nearly $390 million in deductions for abandonment losses and amortization for the 1991, 1994, 1995, and 1998 tax years, and accordingly sought a refund.

The issue in the case was whether WaMu could establish Home's cost basis in the intangible assets. The parties generally agreed as to the purchase price that Home paid in each of the mergers, but disagreed as to how the price should be allocated to each item.

The Court of Federal Claims found that WaMu failed to offer sufficient evidence for the Court to make a "reasonable or rational approximation" of the value of the assets and dismissed the claim.

Observation: In reaching its decision, the Court adopted much of the reasoning from a separate Washington Mutual case in the Ninth Circuit involving similar facts *(Washington Mutual, Inc. v. U.S.,* (CA 9 2011) 107 AFTR 2d 2011-1132).

With respect to the RAP rights, the Court disagreed with WaMu's characterization of what the rights actually represent. WaMu said that Home was provided with "contractual approval" to treat the goodwill created by each of the FSLIC mergers as an asset for regulatory accounting purposes. However, the government argued, and the Court agreed, that the nature of the RAP rights was a guarantee that Home could amortize the goodwill created by the FSLIC mergers over a period of up to 40 years, regardless of whether any adverse regulations regarding the amortization period for goodwill were promulgated. Because WaMu misunderstood the nature of the rights, its determinations of their fair market values (FMVs) were unreliable.

And, the Court found that the problematic nature of WaMu's FMV determination for the RAP rights called into doubt its determinations of Home's costs basis in the branching rights. Notably, the intangibles' FMVs were determined by allocating the agreed-upon purchase price among the items, such that if one item is off, it necessarily throws the others off as well. And, apart from the effect of the problematic RAP right FMVs, the Court also found that WaMu's FMV determinations for the branching rights were also unreliable. Among other issues, they were unreasonable in light of the economic conditions prevailing at that time, and they failed to adequately account for the regulatory hurdles that a hypothetical buyer would encounter in seeking to open branches in a new state.

Since WaMu failed to show that its FMV determinations for the RAP rights, branching rights, and other intangible assets acquired through mergers were reliable, it could not show the amount of refund to which it was entitled, and the Court was similarly unable to make a "reasonable or rational approximation" of their values for the purpose of the refund claim. Accordingly, the complaint was dismissed.

Watts, TC Memo 2017-114.

The Tax Court has upheld IRS's determination that two brothers' losses on the disposal of partnership interests were not ordinary abandonment losses, as they claimed on their returns, but rather were capital losses under §741. The Court also rejected the brothers' argument that they received proceeds from the sale which were used to acquire an intangible asset that they were now entitled to amortize, finding this argument contrary to the unambiguous terms of the partnership agreement and otherwise unsupported.

A taxpayer must capitalize an expenditure when it: (1) creates or improves a separate and distinct asset, (2) produces a significant future benefit, or (3) is incurred in connection with the acquisition or creation of a capital asset. (*Lychuck*, (2001) 116 TC 374) Capital expenditures, unlike ordinary and necessary business expenses, must be recovered over time. (*Indopco, Inc. v. Commissioner,* (S Ct 1992) 69 AFTR 2d 92-694)

The amortization of an expenditure begins with determining the basis to be amortized-generally, the capital cost incurred by a taxpayer when buying, creating, or improving an asset. (§1011; §1012) A taxpayer claiming an amortization deduction bears the burden of establishing his or her basis in the asset. (*Cluck,* (1995) 105 TC 324)

Subject to exceptions not applicable in this case, §741 generally requires that taxpayers recognize as capital all gains or losses realized in the sale or exchange of a partnership interest. To the extent that a noncorporate taxpayer incurs capital losses, the taxpayer may deduct those capital losses currently against capital gains and up to $3,000 of ordinary income. (§165(f); §1211(b))

A loss incurred because of the abandonment of worthless property is generally deductible under §165(a) as an ordinary loss if it was incurred in a business or in a transaction entered into for profit. To qualify as an abandonment loss, a taxpayer must demonstrate that: (i) the transaction at issue was not a sale or exchange; and (ii) the taxpayer abandoned the asset, intentionally and affirmatively, by overt act. (Regulation §1.165-2)

Brothers Edwin and Ronnie Watts (brothers) founded Edwin Watts Golf Shops (Golf) in 1968, when they opened a small pro shop concession. By 2003, the business had grown into a strong regional brand operating in 40 locations, doing nearly $200 million in annual sales, employing hundreds, and attracting the interest of potential buyers and investors. The brothers personally owned the real estate underlying 27 of those locations, in addition to Golf's corporate office and main warehouse.

The brothers were initially hesitant to sell or surrender control of Golf, but worked out an arrangement with Wellspring, a private equity firm, to retain an equity interest. Edwin formed a partnership (Partnership), the exclusive purpose of which was to own Golf, and sold Wellspring an 80.5% interest for $93 million. Edwin owned approximately 19%. By 2007, Edwin's ownership stake diminished to 9.7%, and Ronnie owned 7.76%.

The partnership agreement (Agreement) established two classes of partnership interests-preferred and common. Holders of preferred interests were referred to as "preferred partners." The preferred and common classes voted together as a single class, but the two classes diverged by way of the rights, powers, and privileges exclusively granted to the owner of preferred interests, which included preferential priority in any Partnership liquidating distributions. Agreement also provided additional rights and powers to preferred partners owning 50% or more of the outstanding preferred interests. These included the right to receive consideration for their interests calculated according to a certain formula upon an "Exit/Reorganization" transaction, defined in the agreement as one resulting in the conveyance of all or substantially all of Partnership's assets, or the consolidation, merger, liquidation, or transfer of greater than 80% of outstanding Partnership interests. Wellspring's interest comprised preferred interests, and Edwin's was common.

In 2006, Wellspring began looking to sell its Partnership interest. In 2007, the entire Partnership was sold to Sun, another private equity firm, for $87 million. There had been a significantly larger bid, but the brothers opposed it for a variety of reasons, including a desire to save their employees' jobs and to protect their family's rental income stream (they still owned many business locations that were leased to Golf). Approximately $44 million came in the form of Sun's payment of Partnership debts, $35 million was paid directly to Wellspring, and the remainder was fees and other sale expenses. The brothers did not receive any of the proceeds.

The brothers informed their longtime accountant that they had disposed of their interests in Partnership but received no cash proceeds. The accountant determined that the most appropriate manner of reporting the disposal of their interests was to treat the transaction as an abandonment of their partnership interests, generating ordinary losses, and reflected this determination on their 2007 returns.

IRS, upon examination, recharacterized the losses as capital. The brothers challenged this recharacterization in the Tax Court.

The Tax Court agreed with IRS that the losses from the brothers' disposal of their partnership interests were capital losses.

The brothers argued a new "incentive theory" before the Tax Court-that they were entitled to a pro rata share of the cash proceeds from the Sun sale and agreed to surrender their share to Wellspring in order to incentivize Wellspring's sale to Sun, instead of the higher bidder, to preserve their rental income stream and save jobs. They argued that the form of the sale did not comport with its economic reality-that there was an "undocumented oral agreement" with Wellspring and that, in actuality, they realized profits from the Partnership sale and paid these proceeds to Wellspring, resulting in the creation of an amortizable intangible (which is not identified by the Court) with respect to which they were now entitled to recover their basis. (§167, §263)

The Court, however, found that the "incentive theory" was contrary to the unambiguous terms of the Agreement. Namely, the Agreement did not provide for a pro rata split, but rather provided Wellspring a priority payment for its preferred interests in the event of an exit/reorganization transaction, like the sale to Sun. The brothers also failed to introduce any evidence to show the amount due to Wellspring upon the sale; they did not discuss the liquidation priority provisions or identify any factors that would have increased or decreased the amount that would be payable under the Agreement. This further undercut the brothers' argument that they were entitled to any cash proceeds from the sale. The Court noted that the provisions of the Agreement generally functioned to allow Wellspring, as a preferred partner, to recover its investment to the greatest extent possible, "even if that recovery comes at the expense" of the other minority partners.

Accordingly, since they failed to establish that they were entitled to any cash proceeds from the Sun sale, they were not in a position to offer their share to incentivize the sale, and thus did not acquire anything in exchange that they could now amortize.

The Court then addressed the brothers' original return position that the transaction generated ordinary abandonment losses under §165, although the brothers had effectively abandoned this argument in their Tax Court petition, and upheld IRS's determination that the losses were capital losses resulting from a sale or exchange under §741. The brothers failed to show that IRS's determination was incorrect, presenting no evidence to establish their eligibility for abandonment loss deductions. And, in fact, the Court noted that, throughout the trial and in nearly every filing with the Court, the brothers repeatedly characterized the abandonment loss positions taken on their returns as erroneous.

However, the Court declined to impose §6662 accuracy-related penalties against the brothers, finding that they acted reasonably in relying on their longtime accountant who had sufficient experience and expertise to justify such reliance. (§6664(c)))

Wells Fargo & Co v. U.S., (DC MN 09/15/2017) 120 AFTR 2d ¶2017-5242

A district court has determined that a bank, having been denied foreign tax credits for U.K. taxes paid in connection with a Structured Trust Advantaged Repackaged Securities (STARS) transaction that was held to be a sham, could not deduct those taxes. The court found that the bank waived the issue by failing to raise it sooner—and that even if it had been timely raised, the deduction nonetheless would have been disallowed under the sham transaction doctrine.

Both the U.S. and foreign countries may tax the foreign source income of U.S. taxpayers. To ease this double taxation burden, the Code permits most U.S. taxpayers who pay income taxes to a foreign country to either (i) deduct the taxes from gross income for U.S. purposes under §164; or (ii) credit them dollar for dollar against their U.S. income tax liability on foreign source income under §901.

In general, a transaction will be characterized as a sham if "it is not motivated by any economic purpose outside of tax considerations" (the business purpose test), and if it "is without economic substance because no real potential for profit exists" (the economic substance test). *(IEU Indus. Inc. v. U.S., (CA 8 2001) 87 AFTR 2d 2001-2492)*

The sham transaction doctrine is a way for IRS to look beyond technical compliance with the Code to ascertain the real nature of the transaction at issue. Once a transaction is found to be a sham, the transaction is disregarded for federal tax purposes. *(WFC Holdings Corporation v. U.S., (CA 8 2013) 112 AFTR 2d 2013-5815)*

Observation: For transactions entered into after March 30, 2010—i.e., after the time period involved in this case—the Health Care and Education Reconciliation Act (P.L. 111-152, 3/30/2010) added §7701(o). It provides that a transaction is treated as having economic substance under a conjunctive two-prong test only if, apart from Federal income tax effects, both: (1) the transaction changes the taxpayer's economic position in a meaningful way; and (2) the taxpayer has a substantial purpose for entering into the transaction. That is, the taxpayer's non-Federal-income-tax purpose for entering into a transaction must be "substantial."

Wells Fargo engaged in a STARS transaction with Barclays, a British financial-services company. As part of the transaction, Wells Fargo voluntarily subjected some of its income-producing assets to U.K. taxation by placing them in a trust with a U.K. trustee, and offset those U.K. taxes by claiming foreign-tax credits on its U.S. returns. Barclays enjoyed significant U.K. tax benefits as a result of Wells Fargo's actions compensated Wells Fargo for engaging in STARS by making a monthly payment.

IRS disallowed the foreign tax credits on the ground that the STARS transaction was a sham. The case was tried to a jury, which decided that the larger STARS transaction consisted of two parts—the "trust structure," which gave rise to the foreign tax credits, and the loan—and determined that the trust structure was a sham.

After being notified of the jury's decision, the court informed the parties that it would give them some time to discuss the verdict and figure out next steps—basically, identify the issues that still had to be resolved before a judgment could be entered. After some discussion, the parties identified two remaining issues: (1) whether Wells Fargo was subject to a negligence penalty under §6662(b)(1) in connection with its claim of foreign tax credits; and (2) whether the loan portion of the STARS transaction should be disregarded as a sham.

The court issued an order directing the parties to submit a proposed form of judgment. However, Wells Fargo instead submitted a letter asserting that there remained one final legal issue to be resolved: whether it can deduct the foreign taxes that it paid despite the fact that it cannot receive a credit for them.

IRS contended that Wells Fargo waived this issue and, regardless, was not entitled to a deduction. The court agreed with IRS that Wells Fargo had waived this issue. The court had asked the parties to identify every remaining legal issue that had to be resolved before it could enter judgment, and Wells Fargo and IRS explicitly agreed to only the two issues noted above. At no time during the briefing and resolution of those issues did Wells Fargo notify the court or opposing counsel that there were any other legal issues to be resolved before the entry of judgment.

The court also noted that Wells Fargo was aware of the issue, as it was pleaded in an amended complaint and mentioned in a trial brief. Thus, reasoned the court, while the failure to raise the issue immediately after the verdict could have been attributable to inadvertence, "it is impossible to believe that Wells Fargo's subsequent months-long silence was unintentional."

The court also agreed with IRS that, even if the issue hadn't been waived, Wells Fargo would not be entitled to deduct the foreign taxes based on the application of the sham transaction doctrine. Since the trust structure was disregarded as a sham, Wells Fargo isn't entitled to claim any tax benefits flowing from it.

Wells Fargo argued that courts do not necessarily disregard all aspects of a transaction found to be a sham, noting that in some cases, a taxpayer can claim tax benefits on the basis of "separable, economically substantive elements" of a sham transaction. While the court agreed in principle, it found that in this case the trust structure was found to be a sham, and the foreign tax payments were directly connected with and made in furtherance of the trust structure. Wells Fargo also asserted a number of other arguments in support of its entitlement to the deduction, but the court found that these arguments were foreclosed by the sham transaction doctrine.

Wells Fargo & Company, (DC MN 5/24/2017) 119 AFTR 2d ¶ 2017-797.

A district court in the Eighth Circuit has held that the objective and subjective components of the economic substance test are two factors in a single flexible analysis, that interest that Wells Fargo paid on a loan incurred as part of a Structured Trust Advantaged Repackaged Securities (STARS) transaction was deductible, and that Wells Fargo was subject to the negligence penalty with respect to STARS-generated foreign tax credits that it took.

To determine whether a transaction has economic substance, courts usually make a two-pronged factual inquiry:

1. Was the taxpayer motivated by no business purpose (other than getting tax benefits) in entering into the transaction? (Subjective test)

2. Did the transaction have objective economic substance, i.e., was there a reasonable possibility of a profit? (Objective test) (*Frank Lyon Co v. U.S.,* (S Ct 1978) 41 AFTR 2d 78-1142)

This economic substance (also called "sham transaction") doctrine allows IRS to look beyond technical compliance with the Code to ascertain the real nature of the transaction at issue.

The Circuits have differed in their application of the two-prong test. The Fourth Circuit requires only that a transaction have either a subjective business purpose or objective economic substance in order to be respected (the disjunctive test). (*Rice's Toyota World Inc. v. Commissioner,* (CA 4 1985) 55 AFTR 2d 85-580) On the other hand, the Eleventh Circuit *(United Parcel Service of America Inc.,* (CA 11 2001) 87 AFTR 2d 2001-2565), the Federal Circuit (*Coltec Industries Inc. v. U.S.,* (Ct Fed Cl 2004) 94 AFTR 2d 2004-6708), the Sixth Circuit (*Dow Chemical CO v. U.S.,* (CA 6 2006) 97 AFTR 2d 2006-671), and the Fifth Circuit (*Klamath Strategic Investment Fund v. U.S.,* (CA 5 2009) 103 AFTR 2d 2009-2220) require both (the conjunctive test).

Observation: For transactions entered into after March 30, 2010-i.e., after the time period involved in this case-the *Health Care and Education Reconciliation Act* (P.L. 111-152, 3/30/2010) added §7701(o). It provides that a transaction is treated as having economic substance under a conjunctive two-prong test only if, apart from Federal income tax effects, both: (1) the transaction changes the taxpayer's economic position in a meaningful way; and (2) the taxpayer has a substantial purpose for entering into the transaction. That is, the taxpayer's non-Federal-income-tax purpose for entering into a transaction must be "substantial."

Under §6662(b)(1), a taxpayer is liable for a 20% penalty on any portion of an underpayment that is attributable to negligence. The statute defines "negligence" to "include...any failure to make a reasonable attempt to comply with the provisions of this title..." (§6662(c))

Regulation §1.6662-3 further refines the meaning of "negligence." Among other things, the regulation provides that "a return position that has a reasonable basis as defined in [Regulation §1.6662-3(b)(3)] is not attributable to negligence." (Regulation §1.6662-3(b)(1)) Regulation §1.6662-3(b)(3), in turn, states that a return position "will generally satisfy the reasonable basis standard" if it is "reasonably based on one or more of the authorities set forth in Regulation §1.6662-4(d)(3)(iii)."

Barclays Bank developed STARS, which it marketed to other companies. STARS was a complex series of transactions involving Barclays and another company.

Stripped to its essence, STARS called for a U.S. taxpayer, in this case Wells Fargo, to establish a trust containing revenue-producing bank assets. The monthly revenue from the trust was then cycled through a United Kingdom (U.K.) trustee, an act that served as a basis for U.K. taxation. Although the revenue was immediately returned to Wells Fargo's trust, the assessment of U.K. taxes generated foreign tax credits that were shared 50/50 between Barclays and Wells Fargo.

A $1.25 billion loan from Barclays to Wells Fargo also was part of the structured transaction. And, Barclays made monthly payments to Wells Fargo which represented Wells Fargo's share of the tax credits. The loan interest rate actually was higher than normal for Wells Fargo until these Barclays payments were taken into account. With those payments taken in account, the interest rate was so low that for nearly the first three years of the transaction, Barclays, the lender, made payments to Wells Fargo, the borrower, exceeding by millions the interest payments due from Wells Fargo to Barclays.

IRS sought to disallow both Wells Fargo's foreign tax credits and its deductions for the interest paid on the loan, on the grounds that the transactions that generated the credits and deductions did not have economic substance.

In *Wells Fargo & Company,* (DC MN 2015) 116 AFTR 2d 2015-6738 (Wells Fargo I), a jury adopted IRS's view that STARS consisted of two separate, independent transactions-a trust structure and a loan. As instructed, the jury then determined whether each transaction had a business purpose and economic substance. The jury found that the trust structure had neither a non-tax business purpose nor a reasonable possibility of pre-tax profit. Thus, the jury found that the trust structure (which generated the disputed foreign-tax credits) was a sham.

The jury had a different view of the loan, however. The jury found that the loan had a reasonable possibility of pre-tax profit but that Wells Fargo entered into the loan solely for tax-related reasons.

The Wells Fargo I court then asked the parties to brief the following issues for further consideration by the court: Will a transaction be disregarded as a sham if it had objective economic substance but the taxpayer lacked a subjective non-tax business purpose? Is Wells Fargo subject to a negligence penalty in connection with its claim of foreign-tax credits?

In order to limit the scope of discovery in the current case, Wells Fargo stipulated that it would assert only two defenses to IRS's negligence penalty claim: (1) that STARS was not a sham and therefore Wells Fargo is not liable at all, and (2) that even if STARS was a sham, there was an objectively reasonable basis for Wells Fargo's return position under the authorities referenced in Regulation §1.6662-3(b)(3). Wells Fargo further agreed that, in establishing reasonable basis in its argument against imposition of the negligence penalty, it would not make a contention that relied on its efforts to exercise ordinary and reasonable care in the preparation of its tax return, or its efforts to determine its proper tax liability under the internal revenue laws arising out of the STARS Transaction.

The court concluded that the loan part of the STARS transaction had economic substance and thus the interest on the loan was deductible by Wells Fargo.

IRS argued that, even if a transaction has objective economic substance, it must be treated as a sham unless the taxpayer actually had at least one subjective, non-tax business purpose.

The court noted that three other cases involving materially identical STARS transactions-*Santander Holdings USA, Inc.,* (CA 1 2016) 118 AFTR 2d 2016-6914; *Bank of N.Y. Mellon Corporation ,* (CA 2 2015) 116 AFTR 2d 2015-6014; and *Salem Financial, Inc.,* (CA FC 2015) 115 AFTR 2d 2015-1835 -have found that a STARS loan was not a sham. The court here said that, to resolve the issue before it, it was necessary to predict which approach to the sham transaction doctrine the Eighth Circuit will choose to adopt.

The court concluded that the Eighth Circuit is likely to treat the objective and subjective components of the sham transaction test as two factors in a single flexible analysis rather than as two separate, rigid tests. After all, it said, courts created the sham transaction doctrine in recognition of the fact that taxpayers display endless ingenuity in exploiting the tax code, making it impossible for Congress to anticipate and prevent all abuse. A doctrine that is intended to counter the creative and ever-evolving abuse of the tax code must necessarily be flexible. Reducing the sham transaction doctrine to two mechanical, all-or-nothing tests would deprive the doctrine of the flexibility needed to accomplish its purpose.

Such a reading makes particular sense in light of the Supreme Court's frequent admonition that taxpayers are allowed to engage in tax planning. For example, *Gregory v Helvering*, (S Ct 1935) 14 AFTR 1191, said, "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." An ironclad requirement that a taxpayer subjectively harbor at least one non-tax reason for engaging in a transaction would make it harder for taxpayers to engage in legitimate tax planning.

This is not to say that taxpayers' subjective motives are irrelevant. Contemporaneous evidence that a taxpayer was motivated solely by tax benefits reinforces other objective evidence that the transaction lacked a real potential for pre-tax profit or had any utility aside from tax avoidance. A flexible approach would allow a court to weigh such evidence without giving rise to absurd results.

The court said that, although some courts have said that the lack of a business purpose can by itself invalidate a transaction, the actual results in those cases indicate either that this language was dicta or that the taxpayer's subjective motives became less important when the transaction had substantial objective economic substance.

Salem Financial (the STARS case decided by the Federal Circuit) is illustrative of the latter approach. The Salem Financial Court said that the sham transaction doctrine may well apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance Nevertheless, the Federal Circuit overturned the lower court's ruling that the STARS loan was a sham. And it did so despite the lower court's finding that the taxpayer's sole reason for taking out the loan was to provide a pretext of a business purpose for the STARS transaction. The Federal Circuit "blew past this finding," essentially regarding it as outweighed by the objective economic substance of the loan.

The court said that a flexible approach is consistent with the manner in which the Eighth Circuit has applied the sham transaction doctrine. For example, in determining whether a transaction has economic substance, the Eighth Circuit has focused not merely on whether the transaction generated a non-tax-related profit, but on the size of that profit. The Eighth Circuit has said that "modest profits relative to substantial tax benefits are insufficient to imbue an otherwise dubious transaction with economic substance." (*WFC Holdings Corporation ,* (CA 8 2013) 112 AFTR 2d 2013-5815) In other words, the objective component of the test is not a simple bright-line accounting rule under which one dollar in profits equals economic substance.

Applying this approach, the court held that the loan was not a sham and that Wells Fargo was entitled to deduct its interest expenses. As the jury found, the loan was a real transaction that had substantial, non-tax-related economic effects on the parties. The fact that Wells Fargo would not have entered into the loan but for the opportunity to gain unrelated tax benefits did not change that fact. And although Wells Fargo's purpose in entering the loan was not to borrow money from Barclays but to disguise the sham nature of STARS, the loan was not economically integral to the trust structure and did not play a role in generating the abusive foreign-tax credits. The loan proceeds were available for petitioner to use in its banking business. Accordingly, the loan served a purpose beyond the creation of tax benefits.

The court then said, agreeing with IRS, that, in order to establish the Regulation §1.6662-3(b)(1) reasonable basis defense, Wells Fargo would have to prove that it actually relied on the authorities that form the basis of that defense. Because Wells Fargo's stipulation waived its right to prove actual reliance, Wells Fargo could not establish the defense and therefore it was subject to the negligence penalty for the underpayments associated with the IRS's disallowance of Wells Fargo's claimed foreign-tax credits.

The court said that Wells Fargo's stipulation gave rise to a legal question: Is it enough for Wells Fargo to show that its return position had a reasonable basis under the authorities referenced in Regulation §1.6662-3(b)(3)? Or must Wells Fargo prove that it actually consulted those authorities in preparing its tax return? It answered "no" to the first question and "yes" to the second.

The ordinary meaning of the term "negligence" indicates that the focus of the inquiry should be on whether the taxpayer exercised due care. The statutory definition of "negligence" comports with this view- §6662(c) states that "the term 'negligence' includes any failure to make a reasonable attempt to comply with the provisions of this title." Case law likewise confirms that, in determining whether the negligence penalty applies, the focus is on the taxpayer's conduct. For example, *Chakales,* (CA 8 1996) 77 AFTR 2d 96-1499, provided "the burden is on the taxpayer to prove that he did not fail to exercise due care or do what a reasonable and prudent person would do under similar circumstances."

Regulation §1.6662-3(b)(3) provides that the reasonable-basis standard is generally satisfied "if a return position is reasonably based on one or more" of a set of authorities. This language suggests that the taxpayer must have actually consulted those authorities. "It is difficult to know how a taxpayer could 'base' a return position on a set of authorities without actually consulting those authorities."

REG-116256-17. Preamble to Proposed Regulation 10/11/2017 Proposed Regulation §1.754-1

Proposed regulations that remove the signature requirement under the current basis adjustment regulations. The proposed regulations are effective when finalized, but taxpayers may rely on them for earlier periods. Accordingly, partnerships that filed a timely partnership return containing an otherwise valid §754 election statement, but for the missing signature of a partner on the statement, do not need to seek “9100 relief,” i.e., an extension of time for making an election.

§754 provides that if a partnership files an election (a §754 election), in accordance with regulations, the basis of partnership property is adjusted, in the case of a distribution of property, in the manner provided in §734 and, in the case of a transfer of a partnership interest, in the manner provided in §743. The election applies with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the tax year with respect to which the election was filed and all subsequent tax years. The election may be revoked by the partnership, subject to limitations provided by regulations.

Current Regulation §1.754-1(b)(1) provides the method to make the §754 election, including the requirement that a §754 election must be made in a written statement (§754 election statement) filed with the partnership return for the tax year during which the distribution or transfer occurs. For the §754 election to be valid, the return must be filed not later than the time prescribed for filing the return for the tax year, including extensions. Regulation §1.754-1(b)(1) requires that the §754 election statement (i) set out the name and address of the partnership making the election; (ii) be signed by any one of the partners; and (iii) contain a declaration that the partnership elects under §754 to apply the provisions of

§734(b) and §743(b). Accordingly, under current Regulation §1.754-1(b), a partnership that files an unsigned §754 election statement with its partnership return (whether filed electronically or in paper) has not made a valid election.

Currently the only remedy for failing to make a proper §754 election is to request "9100 relief" to make a late §754 election either: (1) through automatic relief, if the error is discovered within 12 months pursuant to Regulation §301.9100-2; or (2) through a private letter ruling request pursuant to Regulation §301.9100-3. IRS has received numerous requests for 9100 relief with respect to unsigned §754 election statements, especially where returns have been filed electronically.

In order to ease the burden on partnerships seeking to make a valid §754 election and to eliminate the need to seek 9100 relief, the proposed regulation amends the current regulations to remove the signature requirement in Regulation §1.754-1(b)(1).

Under the proposed regulations, a taxpayer making a §754 election must file a statement with its return that: (i) sets out the name and address of the partnership making the §754 election; and (ii) contains a declaration that the partnership elects under §754 to apply the provisions of §734(b) and §743(b).

Preamble to Proposed Regulation 06/13/2017, Proposed Regulation §301.6221(a)-1, Proposed Regulation §301.6221(b)-1, Proposed Regulation §301.6222-1, Proposed Regulation §301.6223-1, Proposed Regulation §301.6223-2, Proposed Regulation §301.6225-1, Proposed Regulation §301.6225-2, Proposed Regulation §301.6225-3, Proposed Regulation §301.6225-4, Proposed Regulation §301.6226-1, Proposed Regulation §301.6226-2, Proposed Regulation §301.6226-3, Proposed Regulation §301.6226-4, Proposed Regulation §301.6227-1, Proposed Regulation §301.6227-2, Proposed Regulation §301.6227-3, Proposed Regulation §301.6241-1, Proposed Regulation §301.6241-2, Proposed Regulation §301.6241-3, Proposed Regulation §301.6241-4, Proposed Regulation §301.6241-5.

IRS has reissued 277 pages of proposed regulations on the new centralized partnership audit regime that was enacted as part of the *Bipartisan Budget Act of 2015* (the BBA, P.L. 114-74, 11/2/2015). The proposed regulations provide rules for partnerships subject to the new regime, including procedures for electing out of the regime, filing administrative adjustment requests, and the determination of amounts owed by the partnership or its partners attributable to adjustments that arise out of an examination of a partnership. The proposed regulations also address the scope of the centralized partnership audit regime and provide definitions and special rules that govern its application, including the designation of a partnership representative.

Observation: Following the initial issuance of these proposed regulations in January of 2017, the Trump Administration instituted a "regulatory freeze", and these regulations were accordingly withdrawn by IRS for further review and approval. They have now been reissued, and they are virtually identical to the withdrawn regulations.

The unified partnership audit and litigation rules currently in effect were enacted as part of the *Tax Equity and Fiscal Responsibility Act of 1982* (TEFRA, P.L. 97-248, 9/3/1982) and are commonly referred to as the TEFRA partnership procedures They are found in Subchapter C of Chapter 63 (§6221 through §6235). Under these rules, IRS generally cannot adjust partnership items on a partner's return except by a unified entity-level proceeding, which is binding on all partners and allows IRS to make the necessary corresponding adjustments on the partners' individual returns. Simplified procedures apply for electing large partnerships, the existing rules applicable to which are found in Subchapter D of Chapter 63 (§6240 through §6255) and Part IV of Subchapter K (§771 through §777).

Generally effective for tax years beginning after December 31, 2017, §1101 of the BBA repealed the TEFRA partnership procedures and the existing rules applicable to electing large partnerships, replacing them with the new rules described below. However, partnerships are allowed to elect to have most of the new partnership audit regime apply to returns of the partnership filed for partnership tax years beginning after November 2, 2015 (i.e., the BBA's enactment date) and before January 1, 2018.

The *Protecting Americans from Tax Hikes Act of 2015* (PATH Act, P.L. 114-113, 12/18/2015) made a number of corrections and clarifications to certain amendments made by the BBA which are effective as if they were originally included in the BBA.

BBA §1101 contains the new partnership audit regime, adding a new subchapter C to chapter 63 of the Code-with largely the same numbers as those that were repealed.

Under new §6221, in general, any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership tax year (and any partner's distributive share thereof) will be determined, and any tax attributable thereto will be assessed and collected, at the partnership level. The applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item or share will also be determined at the partnership level.

New §6221(b) will allow partnerships that are required to furnish 100 or fewer Schedules K-1, Partner's Share of Income, Deductions, Credits, etc. to elect out of this new regime. Generally, a partnership will be able to elect out only if each of its partners is an individual, corporation (including certain types of foreign entities), or estate. Special rules will apply for purposes of determining the number of partners in the case of a partner that is an S corporation. §6221(b)(2)(C) provides that IRS, by regulation or other guidance, may prescribe rules for purposes of the 100-or-fewer-Schedule K-1 requirement similar to the rules for S corporations with respect to any partner that is not an individual, corporation, or estate.

New §6225 provides rules for how partnership adjustments will be made by IRS, including how an imputed underpayment will be determined and that the amount of any imputed underpayment resulting from an adjustment will have to be paid by the partnership (subject to an exception, below). The PATH Act also added a special rule (in new §6225(c)) that addresses certain passive losses of publicly traded partnerships. The rules for how interest and penalties will be computed on an imputed underpayment are provided in new §6233.

Under new §6227, the partnership will be able to request an administrative adjustment, which will be taken into account in the year the administrative adjustment request (AAR) is made. The partnership will generally have three years from the date of filing the return to make an AAR for that year, but will not be able to make an AAR for a partnership tax year after IRS has mailed the partnership a notice of an administrative proceeding with respect to the tax year.

New §6231 describes notices of proceedings and adjustments, including applicable time frames for mailing the notices and the authority to rescind any notice of adjustment with the partnership's consent.

New §6232(a) provides that any imputed underpayment will be assessed and collected in the same manner as if it were a tax imposed for the adjustment year by subtitle A, except that in the case of an

AAR that reports an underpayment that the partnership elects to pay, the underpayment will be paid when the request is filed.

Overview

The proposed regulations would affect partnerships for tax years beginning after December 31, 2017 and any partnerships that elect application of the centralized partnership audit regime pursuant to Regulation §301.9100-22T for tax years beginning after November 2, 2015 and before January 1, 2018. The regulations also withdraw previously issued proposed regulations on the conversion of partnership items related to listed transactions.

The proposed regulations would take an expansive view of the scope of the centralized partnership audit regime to cover all items and information related to or derived from the partnership. Under Proposed Regulation §301.6221(a)-1, all items required to be shown or reflected on the partnership's return and information in the partnership's books and records related to a determination of such items, as well as factors that affect the determination of items of income, gain, loss, deduction, or credit, would be subject to determination and adjustment at the partnership level under the centralized partnership audit regime. Further, the proposed regulations would provide that any chapter 1 tax resulting from an adjustment to items under the centralized partnership audit regime is assessed and collected at the partnership level. The applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item or share would also be determined at the partnership level.

Proposed Regulation §301.6221(b)-1(b) would provide that only an eligible partnership may elect out of the centralized partnership audit regime. Under that section, a partnership is an eligible partnership if it has 100 or fewer partners during the year and, if at all times during the tax year, all partners are eligible partners, as defined in Proposed Regulation §301.6221(b)-1(b)(3). Proposed Regulation §301.6221(b)-1(c) would provide the time, form, and manner for the partnership to make an election out of the centralized partnership audit regime, and unless all of these requirements were satisfied, an election would not be valid.

Proposed Regulation §301.6222-1(a)(1) would provide that a partner's treatment of each item of income, gain, loss, deduction, or credit attributable to a partnership would have to be consistent with the treatment of those items on the partnership return, including treatment with respect to the amount, timing, and characterization of those items. Additionally, Proposed Regulation §301.6222-1(a)(1) would clarify that the determination of whether a partner treats an item consistently with the partnership return is determined with reference to the treatment of that item on the partnership return filed with IRS, and not with reference to any schedule or other information provided or furnished by the partnership to the partner-for example, a schedule K-1 furnished to the partner by the partnership-unless the election under Proposed Regulation §301.6222-1(d), regarding incorrect statements or information, applied.

Proposed Regulation §301.6223-1 would provide: rules requiring a partnership to designate a partnership representative (Proposed Regulation §301.6223-1(a)), rules describing the eligibility requirements for a partnership representative (Proposed Regulation §301.6223-1(b)), rules describing designation of the partnership representative (Proposed Regulation §301.6223-1(c) - Proposed Regulation §301.6223-1(f), and rules describing the termination of a designation of a partnership representative (Proposed Regulation §301.6223-1(d) - Proposed Regulation §301.6223-1(f)).

Proposed Regulation §301.6225-1(a) would provide the general rule that if a partnership adjustment results in an imputed underpayment, the partnership must pay the imputed underpayment in the adjustment year. As described in Proposed Regulation §301.6225-1(a)(3), the partnership adjustments and any imputed underpayment resulting from such adjustments are set out in a notice of proposed partnership adjustment (NOPPA) mailed to the partnership and partnership representative. The partnership may request modification with respect to an imputed underpayment set forth in the NOPPA under the procedures described in Proposed Regulation §301.6225-2.

Proposed Regulation §301.6226-1(a) would provide that a partnership may elect under §6226 to "push out" adjustments to its reviewed year partners rather than paying the imputed underpayment determined under §6225. If a partnership makes a valid election in accordance with Proposed Regulation §301.6226-1, the partnership is no longer liable for the imputed underpayment. A partnership may make an election under this section with respect to one or more imputed underpayments identified in a final partnership adjustment (FPA). For example, where the FPA includes a general imputed underpayment and one or more specific imputed underpayments, the partnership may make an election under this section with respect to any or all of the imputed underpayments.

Proposed Regulation §301.6227-1(a) would describe the general rules for filing an administrative adjustment request (AAR). In accordance with §6227(a), Proposed Regulation §301.6227-1(a) provides that a partnership may file an AAR with respect to one or more items of income, gain, loss, deduction, or credit of the partnership and any partner's distributive share thereof for any partnership tax year as determined under §6221 and the regulations thereunder.

Proposed Regulation §301.6241-1(a) would provide definitions for purposes of subchapter C of chapter 63 and the proposed regulations.

Under the unified partnership audit rules that apply for tax returns filed for partnership tax years beginning after 2017-except that an election may be made to apply them for any partnership return filed for a tax year beginning after November 2, 2015-any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership tax year (and any partner's distributive share of such) will be determined at the partnership level. Similarly, any tax attributable the adjustment will be assessed and collected, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item or share will also be determined at the partnership level. For a more detailed description of these Code provisions.

Scope of Partnership Audit Regime

Under the proposed regulations, all adjustments and items relating to a partnership would be determined at the partnership level under the centralized partnership audit regime. Accordingly, the proposed regulations would provide that the centralized partnership audit regime covers any adjustment to items of income, gain, loss, deduction, or credit of a partnership and any partner's distributive share of those adjusted items. Proposed Regulation §301.6221(a)-1(b)(1) would define the phrase "income, gain, loss, deduction, or credit" for purposes of the centralized partnership audit regime broadly so that the phrase includes: the character, timing, source, and amount of items; the character, timing, and source of the partnership's activities; contributions to and distributions from the partnership; the partnership's basis in its assets and the value of those assets; the amount and character of partnership liabilities; the separate category (for purposes of the foreign tax credit limitation), timing, and amount of the partnership's creditable foreign tax expenditures; elections made by the partnership; items related to transactions between a partnership and any partner (including disguised sales and guaranteed payments); any items related to terminations of a partnership; and partners' capital accounts.

Proposed Regulation §301.6221(a)-1(b)(2) would define the phrase "a partner's distributive share" to include any partner's share of any item determined at the partnership level; the nature and amount of the partner's interest in the partnership; whether any special allocations apply to any partner; the character and timing of any item or activity required to be taken into account by the partner which is related to any item adjusted at the partnership level under subchapter C of chapter 63 (i.e., the partnership audit regime rules); and any amount required to be taken into account by the partner if the partnership makes an election under §6226.

The proposed regulations would provide that any chapter 1 tax resulting from an adjustment to items under the centralized partnership audit regime is assessed and collected at the partnership level. Proposed Regulation §301.6221(a)-1(b)(3) would define the term "tax" for this purpose to mean tax imposed by chapter 1 of subtitle A of the Code. Accordingly, for purposes of assessment and collection at the partnership level, taxes not covered by the centralized partnership audit regime would include taxes imposed by chapter 2 (self-employment income tax), chapter 2A (unearned income Medicare contribution), chapter 3 (withholding of tax on nonresident aliens and foreign corporations), chapter 4 (taxes to enforce reporting on certain foreign accounts), and chapter 6 (consolidated returns), as well as taxes imposed by other subtitles of the Code, such as subtitle C (employment taxes). IRS may separately examine the partnership or its partners outside the centralized partnership audit regime for purposes of determining and assessing these types of taxes.

Determinations regarding items covered by the centralized partnership audit regime may be relied upon by IRS when making determinations of taxes not covered by chapter 1 to the extent they are relevant in making such determinations. (Proposed Regulation §301.6221(a)-1(d))

Under Proposed Regulation §301.6221(a)-1(a), the applicability of any penalty, addition to tax, or additional amount that relates to an adjustment under subchapter C of chapter 63 would be determined at the partnership level. Proposed Regulation §301.6221(a)-1(c) provides that any defenses to any penalty, addition to tax, or additional amount under subchapter C of chapter 63 may only be raised or considered in a partnership proceeding initiated under subchapter C of chapter 63. The partnership representative is the sole representative of the partnership. Accordingly, only the partnership representative would be able to raise defenses to penalties, additions to tax, or additional amounts, including the partnership's defenses and defenses that relate to any partner. For example, if the partnership believes it has a viable reasonable cause defense, the partnership representative would have to raise this defense as part of the partnership proceeding. Any defense, whether it relies on facts and circumstances relating to the partnership or one or more partners or any other person, that was not raised by the partnership before a final determination under subchapter C of chapter 63 would be waived and would not be considered if raised by any other person, including a partner that received a §6226 statement as a result of the partnership making an election under §6226.

Electing Out Partnership Audit Regime

Proposed Regulation §301.6221(b)-1(b) would provide that only an eligible partnership may elect out of the centralized partnership audit regime. A partnership would be an eligible partnership if it has 100 or fewer partners during the year and, if at all times during the tax year, all partners were eligible partners.

Under Proposed Regulation §301.6221(b)-1(b)(2), a partnership would have 100 or fewer partners during the year if it is required to furnish 100 or fewer statements under §6031(b) during the tax year for which the partnership makes the election (only statements required to be furnished are taken into account).

Under §6221(b), the determination of whether the partnership has 100 or fewer partners is made by counting the number of statements required to be furnished under §6031(b). Under TEFRA, §6231(a)(1)(B) (prior to amendment by the BBA) specifically states that a husband and wife were treated as a single partner for purposes of determining whether the partnership had 10 or fewer partners (the TEFRA small partnership exception). §6221(b) contains no similar language. Accordingly, the principles of §6031(b), which do not treat a husband and wife as a single partner, would apply for purposes of determining whether the partnership has 100 or fewer partners. (Proposed Regulation §301.6221(b)-1(b)(2)(iii), Examples 1 and 2)

Under the proposed regulations, a special rule would apply for partnerships that have S corporation partners. Proposed Regulation §301.6221(b)-1(b)(2)(ii) would provide that any statements required to be furnished by the S corporation partner under §6037(b) for the tax year of the S corporation ending with or within the partnership's tax year would be taken into account for purposes of determining whether the partnership was required to furnish 100 or fewer statements for the tax year. For example, if an S corporation with 50 shareholders is a partner in a partnership, in addition to the statement the partnership is required to furnish to the S corporation, the 50 statements that the S corporation is required to furnish to its shareholders under §6037(b) will be taken into account for purposes of determining whether the partnership is required to issue 100 or fewer statements. This special rule would not apply to partners that are not S corporations. (Proposed Regulation §301.6221(b)-1(b)(2)(iii), Example 5)

Proposed Regulation §301.6221(b)-1(b)(3)(i) would define the term "eligible partner" as any person who is an individual, C corporation, eligible foreign entity, S corporation, or an estate of a deceased partner. A C corporation is an entity defined in §1361(a)(2), including a regulated investment company (RIC) and a real estate investment trust (REIT). IRS intends to continue to treat an organization that is determined to be, or claims to be, exempt from tax under §501(a) and is classified as a corporation under §7701(a)(3), as a C corporation for this purpose. An "eligible foreign entity" is defined in proposed Regulation §301.6221(b)-1(b)(3)(iii) as any foreign entity that is classified as a per se corporation under Regulation §301.7701-2(b)(1), Regulation §301.7701-2(b)(3) - Regulation §301.7701-2(b)(8), is classified by default as an association taxable as a corporation under Regulation §301.7701-3(b)(2)(i)(B), or is classified as an association taxable as a corporation in accordance with an election under Regulation §301.7701-3(c). Proposed Regulation §301.6221(b)-1(b)(3)(ii) would clarify that the term "eligible partner" does not include partnerships, trusts, foreign entities that are not eligible foreign entities, disregarded entities, nominees, other similar persons that hold an interest on behalf of another person, and estates that are not estates of a deceased partner.

Under Proposed Regulation §301.6221(b)-1(c)(1), a partnership would make the election only on a timely filed partnership return (including extensions) (that is, Form 1065, U.S. Return of Partnership Income) for the partnership tax year to which the election relates. Accordingly, a partnership may not make the election on a return that is filed after the due date (including extensions) for the tax year. An election out made by a partnership may only be revoked with IRS's consent. (Proposed Regulation §301.6221(b)-1(c)(1))

Proposed Regulation §301.6221(b)-1(c)(2) would provide that a partnership must disclose to IRS the names, correct taxpayer identification numbers (TINs), and federal tax classifications of all partners of the partnership and, if there is an S corporation partner, the names, correct TINs, and federal tax classifications of all persons to whom an S corporation partner is required to furnish statements during the S corporation partner's tax year ending with or within the partnership's tax year at issue, and any other information regarding those partners (and shareholders) as required by IRS in forms and instructions.

Proposed Regulation §301.6221(b)-1(c)(3) would provide that a partnership that elects out of the centralized partnership audit regime must notify each of its partners that the partnership made the election within 30 days of making the election. The notice may be in writing, electronic, or other form chosen by the partnership.

Proposed Regulation §301.6221(b)-1(d) would clarify that any election out of the centralized partnership audit regime by an eligible partnership that is a partnership-partner has no effect on the application of the centralized partnership audit regime to that partnership-partner in its capacity as a partner in another partnership.

Proposed Regulation §301.6221(b)-1(e) would provide that, if a partnership makes an election out, IRS may rely on that election for all purposes unless and until IRS determines that the election is invalid. Proposed Regulation §301.6221-1(e) would provide that an election that is not fully compliant with all the applicable rules, including an election by a partnership not eligible to make the election, may still be relied upon by the partnership unless challenged by IRS, and IRS may also rely upon an election in determining whether a partnership is subject to the centralized partnership audit regime. As a result, it will be clear to partnerships, direct and indirect partners, and IRS which examination and adjustment regime should apply to the items otherwise subject to the centralized partnership audit regime.

Requirement for Partner's Return to Be Consistent with Partnership Return

Under Proposed Regulation §301.6222-1(a)(1), a partner's treatment of each item of income, gain, loss, deduction, or credit attributable to a partnership would have to be consistent with the treatment of those items on the partnership return, including treatment of the amount, timing, and characterization of those items. Additionally, Proposed Regulation §301.6222-1(a)(1) would clarify that the determination of whether a partner treats an item consistently with the partnership return is made with reference to the treatment of that item on the partnership return filed with IRS, and not with reference to any schedule or other information provided or furnished by the partnership to the partner, such as a schedule K-1, unless the election under Proposed Regulation §301.6222-1(d) (dealing with incorrect statements or information) would apply.

Proposed Regulation §301.6241-1(a)(7) would define the term "partnership-partner" to mean a partnership that holds an interest in a partnership. Proposed Regulation §301.6222-1(a)(2) would provide that a partnership-partner is: (1) subject to §6222 and its regulations regardless of whether the partnership-partner has made an election out of the centralized partnership audit regime under §6221. Proposed Regulation §301.6222-1(a)(3) would provide that a partner's return is considered automatically inconsistent if the partnership does not file a return, unless the partner notifies IRS of this inconsistency under Proposed Regulation §301.6222-1(c).

For purposes of the proposed regulations, the term "treatment of items on a partnership return" would be defined under Proposed Regulation §301.6222-1(a)(4), to take into account treatment of all items reported by the partnership, regardless of the form that the reporting of the partnership return position with respect to that item takes (that is, regardless of whether the return position for an item is reflected on an original return or reflected on a statement issued as a result of a partnership-initiated adjustment or an IRS-initiated adjustment). Thus, the term would include not only the treatment of an item on the partnership's return filed with IRS under §6227, but also: (a) any amendment or supplement to such return, such as an administrative adjustment request filed under §6227 and its regulations; and (b) the treatment of an item on any statement, schedule or list, and any amendment or supplement, filed by the partnership with IRS, including statements filed under §6226.

§6222 provides that when a partner fails to treat items attributable to a partnership consistently with the treatment of those items on the partnership return, IRS may assess and collect any underpayment of tax that results from that inconsistency as if it were on account of a mathematical or clerical error appearing on the partner's return; however the ability to request an abatement of the assessment under §6213 does not apply. In general, §6213 allows IRS to immediately assess and collect tax that arises on account of a mathematical or clerical error appearing on a taxpayer's return, notwithstanding the general restrictions on assessment and collection of deficiencies under §6213(a). Under §6213(b), the taxpayer has 60 days to request an abatement of that assessment.

Proposed Regulation §301.6222-1(a) would provide that the underpayment of tax described under §6222 is the amount of tax due that results from adjusting the item on the partner's return to make the treatment of the item consistent with the treatment of such item on the partnership return. Proposed Regulation §301.6222-1(b) would provide that IRS may assess and collect any underpayment of tax that results from adjusting a partner's inconsistently reported item to conform that item with the treatment on the partnership return as if the resulting underpayment of tax were on account of a mathematical or clerical error appearing on the partner's return. A partner would not be able to request an abatement of that assessment. (Proposed Regulation §301.6222-1(b)(2))

Where the partner is itself a partnership, §6222 provides for the use of rules similar to the rules of §6213(b). Under Proposed Regulation §301.6222-1(b), if the partner is itself a partnership, any adjustment on account of such partnership's failure to treat an item consistently would be treated as an adjustment on account of a mathematical or clerical error. The procedures under §6213(b)(2) for requesting abatements would not apply.

Under Proposed Regulation §301.6222-1(c), the provisions of Proposed Regulation §301.6222-1(a) (consistent reporting requirement) and Proposed Regulation §301.6222-1(b) (math error treatment) would not apply to items that the partner properly identifies as being treated inconsistently with the partnership return. To properly identify an item, the partner must attach, to the partner's return on which the item is treated inconsistently, a statement identifying the inconsistency. (Proposed Regulation §301.6222-1(c)(1))

Proposed Regulation §301.6222-1(c)(2) would provide that if a partner's treatment of the item is not consistent with the treatment to which the partner is bound under §6223 with respect to such item, such as the partnership treatment of items in an administrative adjustment request or in a §6226 statement, the consistent reporting requirement and the math error treatment would apply to that item, and any underpayment of tax resulting from the failure to treat the item consistently with the treatment to which the partner is bound, would be assessed and collected in the same way as if the underpayment were on account of a mathematical or clerical error.

Proposed Regulation §301.6222-1(c)(3) would clarify that the exception to the consistent reporting requirement and math error treatment applies only to inconsistent positions that are specifically identified to IRS in a proper notification.

Under §6223(b), a final decision in an administrative or judicial proceeding with respect to a partnership under the centralized partnership audit regime is binding on the partnership and all partners of the partnership. In contrast, under §6222(d), a final determination in an administrative or judicial proceeding with respect to a partner's identified inconsistent position is not binding on the partnership if the partnership is not a party to the proceeding. Accordingly, §6222(d) provides that IRS may conduct a proceeding with respect to the partner, that is, a proceeding that does not involve the partnership, where the partner notified IRS of an inconsistent position under §6222(c). §6222(d) does not, however, preclude IRS from conducting a proceeding with respect to the partnership.

Proposed Regulation §301.6222-1(c)(4)(i) would clarify that in the case of an identified inconsistency, IRS may conduct both a proceeding with respect to the partner (a proceeding in which the partnership would not be involved) and a proceeding with respect to the partnership. Proposed Regulation §301.6222-1(c)(4)(ii) would provide that any final decision with respect to an inconsistent position identified in a notice to IRS under §6222 in a proceeding to which the partnership is not a party is not binding on the partnership.

Proposed Regulation §301.6222-1(c)(4)(ii) also would provide that if IRS conducts a separate proceeding with respect to a partner, IRS is not required to conform items on the partner's return to make those items consistent with the treatment of the items on the partnership return. Rather, if IRS disagrees with the partner's treatment of an inconsistent item, IRS may adjust the item to conform to the proper treatment of such item under federal tax law.

Proposed Regulation §301.6222-1(d) would provide that a partner has provided notice to IRS of an inconsistency if the partner treats an item consistently with incorrect information that the partnership furnished to the partner and makes an election to allow such treatment. Under the proposed regulations, the partner would make the election after being notified by IRS of an adjustment due to treatment of an item on the partner's return inconsistent with the treatment of that item on the partnership's return. As part of the election, the proposed regulations would require the partner to demonstrate that the treatment of the item on the partner's return is consistent with the treatment of that item on the incorrect schedule or information furnished to the partner by the partnership.

Under Proposed Regulation §301.6222-1(d)(2), this election would have to be made within 60 days from the date of the notice informing the partner of the inconsistent treatment. The election would have to be clearly identified as an election under §6222(c)(2)(B), signed by the partner making the election, and accompanied by copies of the schedule or other information furnished to the partner by the partnership as well as the notice mailed by IRS informing the partner of the conforming adjustment. If it is not clear that the partner's treatment of the item on the partner's return is consistent with the information provided by the partnership, the election would have to include an explanation of how the partner's treatment is consistent.

Each partnership must designate in the manner prescribed by IRS a partner or other person with a substantial presence in the U.S. as the partnership representative who will have the sole authority to act on behalf of the partnership. (§6223(a)) In any case in which such designation is not in effect, IRS may select any person as the partnership representative. (§6223(a))

A partnership and all partners of such partnership are bound by actions taken under subchapter C of chapter 63 (the centralized partnership audit rules) by the partnership and by any final decision in a proceeding brought under the centralized partnership audit rules with respect to the partnership. (§6223(b))

§6223 and the concept of the partnership representative replace the tax matters partner (TMP) framework that exists under the previous (TEFRA) partnership procedures. Under the TEFRA rules, a partnership is required to designate a TMP who acts as a liaison between the partnership and IRS. That TMP must be a general partner and may be an individual or an entity.

Partnership Representative Requirement, Eligibility, Designation

The preamble to the proposed regulations sets out the problems that IRS incurred with the TMP framework, which Congress and IRS seek to resolve with the new partnership representative rules. The problems include: (1) Because the TMP has to be a partner, the partnership cannot designate a non-partner, such as a non-partner manager, even if that person is in the best position to understand and have available the partnership's books and records; (2) IRS may be unable to contact the TMP because the TMP is out of the country or simply unreachable. Furthermore, in the case of a TMP that is an entity rather than an individual, IRS must identify and track down an individual who can act for the entity; and (3) while the TMP has the authority to bind the partnership, it cannot bind other partners in the partnership. A partner who is not the TMP also has rights during an examination, including certain notification rights and the right to participate in the proceeding. (Preamble to Proposed Regulation 06/13/2017)

A partnership subject to the centralized partnership audit rules for a partnership tax year would be required to designate a partnership representative for the partnership tax year in accordance with rules in Proposed Regulation §301.6223-1. There could only be one designated partnership representative for a partnership tax year at any time. (Proposed Regulation §301.6223-1(a))

Proposed Regulation §301.6223-1(b)(1) would provide that a partnership may designate any person as defined in §7701(a)(1), including an entity, that meets the requirements of Proposed Regulation §301.6223-1(b)(2), Proposed Regulation §301.6223-1(b)(3), and Proposed Regulation §301.6223-1(b)(4), to be the partnership representative. The partnership representative would have to have a substantial presence in the U.S. (Proposed Regulation §301.6223-1(b)(2)) and the capacity to act. (Proposed Regulation §301.6223-1(b)(1)) The partnership would be able to appoint a partner or a non-partner, including the partnership's management company, as the partnership representative. (Preamble to Proposed Regulation 06/13/2017)

A person would have substantial presence in the U.S. if: (1) the person was able to meet in person with IRS in the U.S. at a reasonable time and place as was necessary and appropriate as determined by IRS; (2) the partnership representative has a street address in the U.S. and a telephone number with a U.S. area code where the partnership representative can be reached by U.S. mail and telephone during normal business hours in the U.S.; and (3) the person has a U.S. taxpayer identification number (TIN). (Proposed Regulation §301.6223-1(b)(2))

If the partnership designated an entity as the partnership representative (an entity partnership representative), Proposed Regulation §301.6223-1(b)(3) would require the partnership to appoint an individual (designated individual) as the sole individual to act on behalf of the entity partnership representative. Like the partnership representative itself, the designated individual would have to meet the substantial presence requirements of Proposed Regulation §301.6223-1(b)(2). If the partnership did not appoint a designated individual, IRS would be able to determine the partnership representative designation was not in effect for purposes of Proposed Regulation §301.6223-1(f). (Proposed Regulation §301.6223-1(b)(3))

In connection with the requirement that a person must have the capacity to act as the partnership representative or the designated individual, Proposed Regulation §301.6223-1(b)(4) describes specific events that would cause a person to lose the capacity to act and includes a catch-all provision for unforeseen circumstances in which IRS reasonably determines that the partnership representative or designated individual may no longer have the capacity to act.

If a partnership representative never met, or no longer meets, the requirements of Proposed Regulation §301.6223-1(b), the designation of the partnership representative would be valid and would remain in effect until the partnership, the partnership representative, or IRS took an affirmative action to terminate that designation. This could happen in one of three ways. The partnership representative could resign pursuant to Proposed Regulation §301.6223-1(d), the partnership could revoke the designation pursuant to Proposed Regulation §301.6223-1(e), or IRS could determine a designation is not in effect under Proposed Regulation §301.6223-1(f). Until one of those events occurs, the designation would be valid and would remain in effect. (Preamble to Proposed Regulation 06/13/2017)

Proposed Regulation §301.6223-1(c) describes the manner in which a partnership would designate the partnership representative. A partnership would be required to designate the partnership representative on the partnership's return filed for the partnership tax year. A partnership would have to designate a partnership representative separately for each tax year. A designation for one tax year would not be effective for any other tax year. A designation for a partnership tax year would remain in effect until the designation was terminated under Proposed Regulation §301.6223-1(d) (resignation), Proposed Regulation §301.6223-1(e) (revocation), or Proposed Regulation §301.6223-1(f) (determination that the designation was not in effect). (Proposed Regulation §301.6223-1(a))

A partnership representative designation could not be changed (either by resignation or revocation) until IRS issued a notice of administrative proceeding to the partnership, except when the partnership filed a valid administrative adjustment request (AAR) in accordance with §6227 and Proposed Regulation §301.6227-1. (Preamble to Proposed Regulation 06/13/2017)

Proposed Regulation §301.6223-1(d) would allow a partnership representative to resign by notifying the partnership and IRS in writing. The partnership representative would not be able to resign prior to the issuance of a notice of administrative proceeding (except in conjunction with the filing of an AAR), but the partnership representative would be able to resign at any time after the issuance of the notice of an administrative proceeding. The partnership representative would be able to resign regardless of whether that person was designated by the partnership or IRS. The resigning partnership representative would be able to, but would not be required to, designate a successor partnership representative. If the resigning partnership representative did not designate a successor, IRS would determine that the designation was not in effect under Proposed Regulation §301.6223-1(f) and would provide the partnership with an opportunity to designate a new partnership representative. If the partnership failed to designate a new partnership representative, IRS would designate a new partnership representative pursuant to Proposed Regulation §301.6223-1(f)(5).

A resignation would be effective 30 days after the date the notice of resignation is sent to IRS. (Proposed Regulation §301.6223-1(d)(1))

Similar rules would apply to designated individuals, allowing the designated individual to resign and appoint a successor. (Proposed Regulation §301.6223-1(d)(3))

Proposed Regulation §301.6223-1(e) describes the rules which would allow the partnership to revoke the partnership representative designation and designate a successor. This revocation provision would be an exception to the general rule that the partnership representative has the sole authority to act on behalf of the partnership.

In the case of a revocation, the partnership would have to notify IRS in writing and also notify the partnership representative of the revocation. Like resignations under Proposed Regulation §301.6223-1(d), the partnership would not be able to revoke the partnership representative designation prior to the issuance of a notice of an administrative proceeding except in conjunction with the filing of a valid AAR.

A revocation would be effective 30 days after the date the notice of revocation is sent to the IRS. Upon the receipt of a valid revocation, IRS would notify the partnership and any partnership representative whose designation was being revoked of the acceptance of the revocation. (Proposed Regulation §301.6223-1(e)(1))

Proposed Regulation §301.6223-1(e)(3)(ii) provides that, with respect to rules for which members of a limited liability company (LLC) would be able to sign a revocation, member-managers would be treated as general partners, and other members would be treated as partners other than general partners. If there was no member-manager, Proposed Regulation §301.6223-1(e)(3)(ii)(B)(3) provides that each member would be treated as a member-manager.

There may be circumstances in which more than one general partner in the partnership makes a revocation within a short period of time. In that circumstance, IRS may not be able to readily determine the identity of the proper partnership representative. (Preamble to Proposed Regulation 06/13/2017) To allow IRS to identify the correct partnership representative, Proposed Regulation

§301.6223-1(e)(5) provides if IRS receives multiple revocations or subsequent designations within a 90-day period, IRS would be able to determine that a designation is not in effect due to multiple revocations and follow the procedures under Proposed Regulation §301.6223-1(f) to designate a new partnership representative. If IRS designates a partnership representative under Proposed Regulation §301.6223-1(f), Proposed Regulation §301.6223-1(e)(4) provides that the partnership would have to receive IRS's permission to later revoke the designation.

Proposed Regulation §301.6223-1(f) provides the rules regarding how IRS would make a determination that a designation of a partnership representative was not in effect, as well as how IRS would designate a partnership representative if a designation was not in effect.

IRS would be able to determine that the partnership representative designation was not in effect in the case of multiple revocations as described in Proposed Regulation §301.6223-1(e)(5) or if IRS determined that: (i) the partnership failed to make a valid designation under Proposed Regulation §301.6223-1(c); (ii) the partnership representative or the designated individual did not have substantial presence or did not have capacity to act (as described in Proposed Regulation §301.6223-1(b)(4)); (iii) the partnership failed to appoint a designated individual (as described in Proposed Regulation §301.6223-1(b)(3) (b)(3), as applicable); or (iv) no successor designation or appointment was made in the case of a resignation without a designation or appointment of a successor. (Proposed Regulation §301.6223-1(f)(2))

Proposed Regulation §301.6223-1(f)(1) provides that if IRS determined a designation was not in effect, IRS would notify the partnership and the last partnership representative, if there was one, of IRS's determination. The designation would be terminated as of the day IRS notified the partnership that no designation was in effect. Proposed Regulation §301.6223-1(f)(4) provides that, except in cases where the partnership designation was not in effect because there were multiple revocations, the partnership would have 30 days to designate a successor partnership representative before IRS would designate a new partnership representative.

If IRS had already received multiple revocations from different partners and determined it was unable to ascertain which partnership representative the partnership wanted to designate, Proposed Regulation §301.6223-1(f)(4) provides that IRS would notify the partnership that the designation was not in effect and would designate a new partnership representative pursuant to Proposed Regulation §301.6223-1(f)(5) without providing the partnership with an opportunity to designate a partnership representative.

Proposed Regulation §301.6223-1(f)(1) provides that if there was no designation of a partnership representative in effect, IRS would be able to select any person to serve as partnership representative. There would be no distinction between the authority of a partnership representative designated by the partnership and one selected by IRS. (Preamble to Proposed Regulation 06/13/2017)

Under Proposed Regulation §301.6223-1(f)(5) the designation by the IRS of a new partnership representative would be effective on the day IRS mails the notification to the partnership of the designation.

In designating a person as the partnership representative, IRS would consider whether the person was a partner in the partnership, either in the reviewed year or at the time the designation was made. (Proposed Regulation §301.6223-1(f)(5)(ii)) In addition, IRS would be able to consider the other factors listed in Proposed Regulation §301.6223-1(f)(5)(ii).

Once IRS designated a partnership representative, the partnership would not be able to revoke that designation without the consent of IRS. (Proposed Regulation §301.6223-1(f)(3)(iii))

The proposed regulations would not require the partnership representative to provide notice to all partners of significant developments in an administrative proceeding or to allow partners other than the partnership representative to participate in the administrative proceeding. (Preamble to Proposed Regulation 06/13/2017)

Binding Effect of Actions of Partnership and Partnership Representative

Under Proposed Regulation §301.6223-2, the partnership and all partners would be bound by the actions of the partnership and the partnership representative and by any final decision in a proceeding brought under subchapter C of chapter 63. The partnership representative would bind the partnership and its partners by the partnership representative's actions, including: agreeing to settlements, agreeing to a notice of final partnership adjustment, making an election under §6226, and agreeing to an extension of the period for adjustments under §6233. In addition, all persons whose tax liability was determined, in whole or in part, by taking into account, directly or indirectly (such as indirect partners), adjustments to any item within the scope of the centralized partnership audit regime, by IRS in a notice of final partnership adjustment in a proceeding brought under subchapter C of chapter 63, or in a final decision of a court under subchapter C of chapter 63, would be similarly bound. This binding authority would extend to all partners, including those partners who elected out of the centralized partnership audit regime under §6221(b). (Proposed Regulation §301.6223-2(a))

Proposed Regulation §301.6223-2(c)(1) provides that the partnership representative would have the sole authority to act on behalf of the partnership in any examination or other proceeding under subchapter C of chapter 63. Similarly, Proposed Regulation §301.6223-2(c)(2)(ii) provides that a designated individual would have the sole authority to act on behalf of the partnership representative and the partnership. Except for a partner that is also the partnership representative or a designated individual, Proposed Regulation §301.6223-2(c)(1) provides that partners would not be able to participate in or contest the results of an examination or other proceeding involving a partnership without permission of IRS. Proposed Regulation §301.6223-2(c)(1) also provides that no other person, regardless of whether that person's tax liability was affected by the actions of the partnership, would be able to participate in the partnership proceeding under subchapter C of chapter 63.

Proposed Regulation §301.6223-2(c)(1) states that the broad authority of the partnership representative would not be able to be limited by state law, partnership agreement, or any other document or agreement. Proposed Regulation §301.6223-2(c)(2)(i) provides that the partnership representative, by virtue of being designated, would have the authority to bind the partnership for purposes of the centralized partnership audit regime.

Under the new rules, any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership tax year, and any partner's distributive share thereof, are determined at the partnership level. In the event of any adjustment by IRS in the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share that results in an "imputed underpayment," the partnership is required to pay the imputed underpayment in the adjustment year. (§6225(a)(1))

Any adjustment that does not result in an imputed underpayment must be taken into account by the partnership in the adjustment year. (§6225(a)(2)) Except for an adjustment to an item of credit, which is taken into account as a separately stated item, an adjustment not resulting in an imputed underpayment must be taken into account as a reduction in non-separately stated income or as an increase in non-separately stated loss (whichever is appropriate) in accordance with §702(a)(8). (§6225(a)(2)(A); §6225(a)(2)(B))

An imputed underpayment of tax with respect to a partnership adjustment for any reviewed year is determined by netting all adjustments of items of income, gain, loss, or deduction and multiplying the net amount by the highest rate of Federal income tax applicable either to individuals or to corporations that is in effect for the reviewed year. (§6225(b)(1)) The product is then increased or decreased, as the case may be, by any adjustments to items of credit under §6225(c).

In the case of an adjustment that reallocates the distributive share of an item from one partner to another, such adjustment is taken into account when determining the imputed underpayment by disregarding any decrease in any item of income or gain and any increase in an item of deduction, loss, or credit. (§6225(b)(2))

§6225(c) provides that IRS will establish procedures under which a partnership may modify an imputed underpayment (modification procedures), with IRS's approval. Anything required to be submitted to IRS under these modification procedures must be submitted within 270 days following the date the notice of proposed partnership adjustment (NOPPA) is mailed under §6231 by the IRS, unless an extension is granted. (§6225(c)(7))

The modification procedures will provide that if one or more partners files amended returns (notwithstanding §6511) for the tax year of the partners that includes the end of the reviewed year of the partnership, the returns take into account all adjustments made by IRS that are properly allocable to such partners (and for any other tax year with which a tax attribute is affected by reason of the adjustments), and payment of any tax due is included with the amended returns. (§6225(c)(2)) In the case of any adjustment that reallocates the distributive share of any item from one partner to another, a modification described in §6225(c)(2) will apply only if amended returns are filed by all partners affected by such adjustment.

The modification procedures will provide that the imputed underpayment will be determined without regard to the portion thereof that the partnership demonstrates is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity described at §168(h)(2). (§6225(c)(3))

In addition, the modification procedures will provide for applying a tax rate lower than the highest tax rate described above to any portion of the imputed underpayment that the partnership demonstrates is allocable to a partner which (i) is a C corporation, or (ii) in the case of a capital gain or qualified dividend, is an individual. (§6225(c)(4)) However, the lower rate determined under this rule cannot be less than the highest rate applicable to the relevant income for the relevant taxpayer. For this purpose, an S corporation will be treated as an individual. (§6225(c)(4)(A))

The portion of the imputed underpayment to which the lower rate applies as to a partner will be determined by reference to the partners' distributive share of items to which the imputed underpayment relates. (§6225(c)(4)(B)(i)) However, if the imputed underpayment is attributable to the adjustment of more than one item, and any partner's distributive share of the items is not the same for all the items, then the portion of the imputed underpayment to which the lower rate applies as to a partner will be determined by reference to the amount that would have been the partner's distributive share of net gain or loss if the partnership had sold all of its assets at their fair market value as of the close of the reviewed year of the partnership. (§6225(c)(4)(B)(ii))

In the case of a publicly traded partnership (as defined in §469(k)(2)) the procedures will provide:

1. For determining the imputed underpayment without regard to the portion that the partnership demonstrates is attributable to (i.e., would be offset by) a net decrease in a "specified passive activity loss" (below) that is allocable to a specified partner, (§6225(c)(5)(A)(i)) and

2. For the partnership to take the net decrease into account as an adjustment in the adjustment year with respect to the specified partners to which the net decrease relates. (§6225(c)(5)(A)(ii))

For these purposes, a specified passive activity loss is, with respect to any "specified partner" (below) of the publicly traded partnership, the lesser of:

a. The passive activity loss of the partner that is separately determined for the partnership under the passive loss rules for the partner's tax year in which or with which the reviewed year of the partnership ends, (§6225(c)(5)(B)(i)) or

b. The passive activity loss so determined for the partner's tax year in which or with which the adjustment year of the partnership ends. (§6225(c)(5)(B)(ii))

A specified partner means any person if such person, with respect to each tax year of such person which is during the period beginning with the tax year of such person in which or with which the reviewed year of such publicly traded partnership ends and ending with the tax year of such person in which or with which the adjustment year of such publicly traded partnership ends, is: (1) a partner of such publicly traded partnership; (2) is described in §469(a)(2); and (3) has a specified passive activity loss with respect to such publicly traded partnership. (§6225(c)(5)(C))

IRS has authority under §6225(c)(6) to issue regulations or other guidance providing additional procedures to modify imputed underpayment amounts on the basis of such other factors it determines are necessary or appropriate to carry out the purposes of §6225(c).

In general, if a partnership adjustment results in an imputed underpayment, the partnership would be required to pay the imputed underpayment in the adjustment year. (Proposed Regulation §301.6225-1(a)) The partnership adjustments and any imputed underpayment resulting from such adjustments would be set forth in a NOPPA mailed to the partnership and partnership representative. (Proposed Regulation §301.6225-1(a)(3)) The partnership would be able to request modification with respect to an imputed underpayment set forth in the NOPPA under the procedures described in Proposed Regulation §301.6225-2.

IRS noted in the preamble that, in the interest of resolving disputes quickly and efficiently, it may agree to review certain information prior to the issuance of the NOPPA, and accordingly encouraged partnerships to provide relevant information to IRS employees conducting the administrative proceeding. However, once the NOPPA is issued, the modification procedures under Proposed Regulation §301.6225-2 are the partnership's only formal route to request changes to an imputed underpayment set forth in the NOPPA. (Preamble to Proposed Regulation 06/13/2017)

Unless IRS determines otherwise, all applicable preferences, restrictions, limitations, and conventions would be taken into account as if the adjusted item was originally taken into account by the partnership or the partners in the manner most beneficial to the partnership or partners. (Proposed Regulation §301.6225-1(a)(2)) So, IRS would calculate an imputed underpayment by taking into account the applicable internal revenue laws, including provisions that may limit or restrict the ability of a partner to reduce income or take advantage of tax benefits flowing from the partnership. The modification procedures (below) would be the method for the partnership to request that IRS modify an imputed underpayment to more closely reflect the tax consequences that would have resulted if the partners had taken the adjusted items into account correctly on their original returns for the year that includes the reviewed year of the partnership.

An imputed underpayment would be calculated by multiplying the total netted partnership adjustment by the highest rate of federal income tax in effect for the reviewed year (as defined in Proposed Regulation §301.6241-1(a)(8)) under §1 or §11. (Proposed Regulation §301.6225-1(c)(1))

The product of that amount would then be increased or decreased by any adjustment made to the partnership's credits. If the result of this summation is a net positive adjustment, the resulting amount would be the imputed underpayment, and if it results in a net non-positive amount, the result would be an adjustment that does not result in an imputed underpayment. (Proposed Regulation §301.6225-1(c)(2))

The "total netted partnership adjustment" for purposes of calculating the imputed underpayment in Proposed Regulation §301.6225-1(c)(1) would be the sum of all net positive adjustments in the residual grouping, plus the sum of all net positive adjustments in the reallocation grouping (below). (Proposed Regulation §301.6225-1(c)(3))

Adjustments would be grouped together, then could be further divided into subgroupings depending on their character or to account for preferences, sources, categories, limitations, or other restrictions. (Regulation §301.6225-1(d)) There would be three types of groupings: adjustments that reallocate items among the partners (reallocation grouping); adjustments to the partnership's credits (credit grouping; generally, all adjustments to items that the partnership claimed or could have claimed as a credit on its return); and all remaining adjustments (residual grouping). (Regulation §301.6225-1(d)(2))

After items are separated into groupings and subgroupings, IRS would net items within the same grouping or subgrouping. (Proposed Regulation §301.6225-2(d)(3)(i) Once this has occurred, each grouping or subgrouping will have either a net positive adjustment (as defined in Proposed Regulation §301.6225-2(d)(3)(ii)(B)) or a net non-positive adjustment (as defined in Proposed Regulation §301.6225-2(d)(3)(ii)(C)). Any netted amount that is a net non-positive adjustment in the reallocation grouping or the residual grouping would be an adjustment that does not result in an imputed underpayment under Proposed Regulation §301.6225-2(c)(2), and the rules described in Proposed Regulation §301.6225-3 would apply regarding the treatment of the partnership adjustments that were netted giving rise to that net non-positive adjustment. Any such net non-positive adjustment would, with limited exception, generally be disregarded for the remaining purpose of calculating the imputed underpayment. (Proposed Regulation §301.6225-1(c)(2); Proposed Regulation §301.6225-1(d)(3)(ii)(A))

Each administrative proceeding that ends with an IRS determination of an imputed underpayment would result in a general imputed underpayment. IRS may determine, in its discretion, a specific imputed underpayment on the basis of certain adjustments allocated to one partner or a group of partners based on the items or adjustments having the same or similar characteristics, based on the group of partners sharing similar characteristics, or based on the partners having participated in the same or similar transactions. There may be multiple specific imputed underpayments depending on the adjustments. (Proposed Regulation §301.6225-1(e)) If the partnership would like to change the number or composition of the imputed underpayments that are listed on the NOPPA, the partnership would be able to request modification under Proposed Regulation §301.6225-2(d)(6).

The partnership representative of a partnership that has received a NOPPA would be able to request modification of a proposed imputed underpayment. (Proposed Regulation §301.6225-2(a)) Also, finding that §6225 "clearly contemplates the possibility of requesting modification with respect to an adjustment that does not result in an imputed underpayment," the proposed regulations would also allow for such modifications provided that the partnership has a proposed imputed underpayment that is set forth in the NOPPA. (Proposed Regulation §301.6225-2(a); Preamble to Proposed Regulation 01/19/2017) If the NOPPA does not set forth an imputed underpayment, the partnership would not be able to request a modification with respect to adjustments that do not result in an imputed underpayment under Proposed Regulation §301.6225-2.

Some modifications could result in excluding certain adjustments, or portions thereof, from the calculation of the imputed underpayment. When IRS approves one of those types of modification, the portion of the partnership adjustment attributable to that partner (or indirect partner) would be removed from the calculation of the netted grouping amounts under Proposed Regulation §301.6225-1, resulting in a reduction of the total netted partnership adjustments underlying the calculation of the imputed underpayment. This reduction in the total netted partnership adjustments would not, however, affect the amount of the partnership adjustment itself, only whether the adjustment is included in the calculation of the imputed underpayment. (Proposed Regulation §301.6225-2(b))

Proposed Regulation §301.6225-2(b)(3) would provide that modification with respect to a partnership with partners for which rate modification under §6225(c)(4) and Proposed Regulation §301.6225-2(d)(4) is approved would affect the taxable rate applied to the total netted partnership adjustment and would not affect the extent to which partnership adjustments factor into the calculation of the imputed underpayment. This rule could also apply in appropriate circumstances to certain other modifications. Specific rules would apply to rate modification with respect to special allocations that require each partner's distributive share to be determined based on the amount of net gain or loss to the partner that would result if the partnership had sold all of its assets at their fair market value as of the close of the reviewed year of the partnership. (Proposed Regulation §301.6225-2(b)(3)(iv))

Modification would have to be requested in the form and manner prescribed by IRS within the 270-day period described in Proposed Regulation §301.6225-2(c)(3)(i). IRS would be able to rely on the facts provided to it by the partnership representative to determine whether a modification request is proper and would not be required to conduct an examination of the partners that form the basis of any modification request. (Proposed Regulation §301.6225-2(c)) A determination with respect to a modification request would not preclude IRS from initiating certain other related types of proceedings, such as examining the tax-exempt status of a partner.

When requesting a modification, the partnership would be required to substantiate the facts supporting its request to IRS's satisfaction and furnish, upon request, a detailed description of the structure, allocations, ownership, and ownership changes of the partnership, its partners, and, if relevant, any indirect partners for each tax year relevant to the request, as well as all partnership agreements (including side agreements) for each relevant tax year with respect to each modification request. A request will be denied if a partnership fails to provide the requisite information. (Preamble to Proposed Regulation 01/19/2017)

The partnership would be able to request an extension of the 270-day period, and the partnership representative and IRS would also be able to agree, in writing, to waive the 270-day delay between the mailing of the NOPPA and when IRS may first issue a final partnership adjustment (FPA). (Proposed Regulation §301.6225-2(c)(3)) The waiver of the 270-day period would prevent the partnership from providing modification-related information after the date the waiver was executed. (Proposed Regulation §301.6225-2(c)(3)(iii))

There would be seven types of modifications IRS would consider if requested by the partnership, as well as alternative forms under Proposed Regulation §301.6226(d)(9), any or all of which may be requested by a partnership unless otherwise stated. The modification types would include modifications based on, among other things, amended returns, the status of a tax-exempt partner, a lower rate of tax than the highest applicable tax rate, and certain passive losses of publicly traded partnerships. The proposed regulations set out a number of detailed rules that would have to be satisfied when seeking a modification based on an amended return, including rules pertaining to the timing of the filing of the return(s). (Proposed Regulation §301.6226(d)(2)) IRS also noted that, in addition to the enumerated types of modification described in Proposed Regulation §301.6225-2(d), it would be able to, in its discretion, consider alternative types of modification not specifically discussed and the necessary substantiation. (Preamble to Proposed Regulation 01/19/2017)

Proposed Regulation §301.6225-1(c)(2) sets out three circumstances in which partnership adjustments would not result in an imputed underpayment:

1. If the adjustment relates to a distributive share reallocation that is disregarded under Proposed Regulation §301.6225-1(d)(2)(ii),

2. If after grouping and netting the adjustments, the result is a net non-positive adjustment under Proposed Regulation §301.6225-1(d)(3)(ii), or

3. If the calculation under Proposed Regulation §301.6225-1(c)(1) results in an amount that is zero or less than zero.

With limited exceptions, such adjustments would be taken into account by the partnership in the adjustment year as a reduction in non-separately stated income or as an increase in non-separately stated loss depending on whether the adjustment is to an item of income or loss. (Proposed Regulation §301.6225-3) The allocation of adjustments that do not result in an imputed underpayment would generally be determined under the partnership agreement, but Proposed Regulation §301.6225-3(b)(3) provides rules that would govern those allocations in limited circumstances.

§6226 provides an alternative to the general rule under §6225(a)(1) that the partnership must pay the imputed underpayment. Under §6226, the partnership may elect to have its reviewed year partners take into account the adjustments made by IRS and pay any tax due as a result of those adjustments. In this case, the reviewed year partners must pay any tax resulting from taking into account the adjustments, and the partnership is not required to pay the imputed underpayment.

To make the §6226 election, a partnership must take two steps with respect to an imputed underpayment: (i) make an election in the manner provided by IRS no later than 45 days after the date the final partnership adjustment (FPA) is mailed by IRS under §6231; (§6226(a)(1)) and (ii) furnish, at the time and in the manner provided by IRS, a statement of each partner's share of any adjustment as determined in the FPA to its reviewed year partners. (§6226(a)(2)) If these steps are taken, §6225 does not apply to the imputed underpayment, and each partner must take its share of the adjustments into account as provided in §6226(b). (§6226(a)) The election is revocable only with IRS's consent. (§6226(a))

The reviewed year partners take the adjustments subject to the §6226 election into account by increasing each partner's income tax, for the tax year that includes the date the statement was furnished, by the aggregate of:

1. For the partner's tax year that includes the end of the reviewed year, the amount by which the partner's income tax would increase if the partner's share of the adjustments were taken into account for the tax year (§6226(b)(2)(A)), plus

2. For any of the partner's tax years after the tax year that includes the end of the reviewed year and before the tax year that includes the date the statement was furnished, the amount by which the partner's income tax would increase by reason of the adjustments to tax attributes (i.e., those that would have been affected if the partner's share of adjustments were taken into account). (§6226(b)(2)(B)) These adjustments to tax attributes would be made by adjusting the relevant attributes for any tax years after the tax year that includes the end of the reviewed year

and before the tax year that includes the date the statement was furnished, and then appropriately adjusting the attributes for later tax years. (§6226(b)(3))

When an election is made under §6226, any penalties, additions to tax, or additional amounts would be determined under §6221 at the partnership level, and the reviewed year partners of the partnership would be liable for any such penalty, addition to tax, or additional amount. (§6226(c)(1))

Interest is determined at the partner level (§6226(c)(2)(A)) and calculated from the due date of the partner's return for the tax year to which the increase in tax is attributable taking into account any increases attributable to a change in tax attributes for an intervening year as determined under §6226(b)(2). (§6226(c)(2)(B)) The interest would be computed at the underpayment rate under §6621(a)(2), substituting five percentage points for three percentage points for purposes of §6621(a)(2)(B) (i.e., the sum of the federal short-term rate plus five percentage points instead of three percentage points). (§6226(c)(2)(C))

Proposed Regulation §301.6226-1(a) would allow partnership to be able to elect under §6226 to "push out" adjustments to its reviewed year partners rather than paying the imputed underpayment determined under §6225. If a partnership makes a valid election, the partnership would no longer liable be for the imputed underpayment. The election would be able to be made respect to one or more imputed underpayments identified in an FPA.

Proposed Regulation §301.6226-1(b)(1) would provide that if a partnership makes a valid election, the reviewed year partners of the partnership would be liable for tax, penalties, additions to tax, and additional amounts, as well interest on such amounts, after taking into account their share of the partnership adjustments determined in the FPA. Any modifications approved by IRS under Proposed Regulation §301.6225-2 would also be reported to the reviewed year partners.

The election would not be valid unless the partnership complies with all applicable requirements, and it would be revocable only with IRS's consent. If IRS determines that an election is invalid, it would notify the partnership and partnership representative within 30 days of its determination and give its reason. A final determination that an election is invalid would mean that the partnership is liable for any imputed underpayment to which the election related, as well as any penalties and interest with respect to the imputed underpayment determined under §6233.

The election would have to be made within 45 days of the date the FPA was mailed by IRS, be signed by the partnership representative, include all required information, and be properly filed with IRS. (Proposed Regulation §301.6226-1(c)(3)) A copy of the FPA to which the election relates would also have to be attached. (Proposed Regulation §301.6226-1(c)(4)) The partnership would have to furnish statements to the reviewed year partners with respect to the partner's share of the adjustments, within 60 days after the date the adjustments become finally determined (i.e., upon the later of the expiration of time to file a petition under §6234 or, if a petition is filed under that section, the date when the court's decision becomes final), and file such statements with IRS. (Proposed Regulation §301.6226-2(a)) All reviewed year partners would be bound by the election and would be required to take the adjustments on the statement into account and pay any additional tax as a result. The proposed regulations describe information required to be included on the statements (Proposed Regulation §301.6226-2(e)), as well as procedures for correcting any errors in statements filed with IRS. (Proposed Regulation §301.6226-2(d))

A reviewed year partner's share of the adjustments that the partner would have to take into account would have to be reported to that partner in the same manner as originally reported on the return filed by the partnership for the reviewed year. (Proposed Regulation §301.6226-2(f)) If the adjusted item was not reflected in the partnership's reviewed year return, the adjustment would have to be reported in accordance with the rules that apply with respect to partnership allocations, including under the partnership agreement. However, if the adjustments, as finally determined, are allocated to a specific partner or in a specific manner, the partner's share of the adjustment would have to follow how the adjustment is allocated in that final determination. (Proposed Regulation §301.6226-2(f))

Any penalties, additions to tax, or additional amounts would be reported to the reviewed year partners in the same proportion as each partner's share of the adjustments to which the penalties relate, unless the penalty, addition to tax, or additional amount is specifically allocated to a specific partner(s) or in a specific manner by a final court decision or in the FPA, if no petition is filed. (Proposed Regulation §301.6226-2(f)(2)) If a penalty, addition to tax, or additional amount does not relate to a specific adjustment, each reviewed year partner's share thereof would be determined in accordance with how such items would have been allocated under rules that apply with respect to partnership allocations, including under the partnership agreement, unless it is allocated to a specific partner in a specific manner in a final determination of the adjustments, in which case it is allocated in accordance with the final determination. (Preamble to Proposed Regulation 06/13/2017)

A reviewed year partner that is furnished a statement under Proposed Regulation §301.6226-2 would be required to pay any additional income tax for the partner's tax year which includes the date the statement was furnished to the partner that results from taking into account the adjustments reflected in the statement. (Proposed Regulation §301.6226-3) This additional tax would be either the aggregate of the adjustment amounts, as determined in Proposed Regulation §301.6226-3(b), or, if an election is made under Proposed Regulation §301.6226-3(c), a safe harbor amount.

The reviewed year partner would also have to pay, for the reporting year, the partner's share of any penalties, additions to tax, or additional amounts reflected in the statement, and any interest on such amounts. Interest would be determined in accordance with Proposed Regulation §301.6226-3(d).

The aggregate of the adjustment amounts would be the aggregate of the relevant "correction amounts" determined under Proposed Regulation §301.6226-3(d) -one correction amount for the partner's tax year which includes the reviewed year of the partnership, and a second for the partner's tax years after the first affected year and before the reporting year. These correction amounts cannot be less than zero, and any amount below zero after applying the rules in Proposed Regulation §301.6226-3(b) would not reduce any correction amount, any tax in the reporting year, or any other amount.

The correction amount for the first affected year would be the amount by which the reviewed year partner's income tax would increase for the first affected year by taking into account the adjustments reflected in the statement provided to the reviewed year partner under Proposed Regulation §301.6226-2. The aggregate correction amount for all intervening years would be the sum of the correction amounts for each intervening year. (Proposed Regulation §301.6226-3(b)(3))

A partner that is furnished a statement described in Proposed Regulation §301.6226-2, including partnership-partners and S corporation partners, would be able to elect, on the partners' return for the reporting year, to pay the safe harbor amount (or the interest safe harbor amount, in the case of certain individuals) shown on the statement in lieu of the additional reporting year tax. (Proposed Regulation §301.6226-3(c)) The safe harbor amount for each reviewed year would be calculated in the same manner as the imputed underpayment under Proposed Regulation §301.6225-1, except that the adjustments allocated to the partner on the statement (including any amounts attributable to adjustments to partnership tax attributes) would be used instead of the adjustments that are taken into account for purposes of determining the imputed underpayment. With one exception (for when a reviewed partner filed an amended return or entered into a closing agreement during the modification phase), any approved modifications of the imputed underpayment, including a rate modification under §6225(c)(4), would have no effect on the determination of the safe harbor amount for any partner.

A partnership would also have to calculate an interest safe harbor amount for partners who are individuals and who have a calendar year tax year, at the rate set forth in Proposed Regulation §301.6226-3(d)(4) from the due date (without extension) of the individual reviewed year partner's return for the first affected year until the due date (without extension) of the individual reviewed year partner's return for the reporting year. A separate safe harbor amount (and interest safe harbor amount, if applicable) would be calculated for each separate statement furnished to the partner under Proposed Regulation §301.6226-2.

Any reviewed year partner would be able elect to pay the safe harbor amount, including reviewed year partners that are partnership-partners or S corporation partners. (Preamble to Proposed Regulation 06/13/2017)

Reviewed year partners would also be liable for interest on any correction amount for the first affected year and any intervening years under Proposed Regulation §301.6226-3(d)(1). If the partner elects to pay the safe harbor amount, a reviewed year partner that is an individual could also elect to pay the interest safe harbor amount. For all other partners and individuals that do not elect the safe harbor amount, interest would apply under Proposed Regulation §301.6226-3(d)(2).

The proposed regulations would coordinate the rules under the centralized partnership audit regime with the deficiency dividend procedures under §860 for partners that are regulated investment companies (RICs) and real estate investment trusts (REITs). Under Proposed Regulation §1.6226-2(h), if a statement described in Proposed Regulation §1.6226-2 is furnished to a reviewed year partner that is a RIC or REIT, the RIC or REIT would be able to take into account the adjustments reflected in the statement that also are "adjustments" within the meaning of §860(d) by using the deficiency dividend procedures set forth in §860, subject to certain limitations. Proposed Regulation §301.6226-3(b)(4) would also coordinate the deficiency dividend rules with the rules for determining the additional reporting year tax under Proposed Regulation §301.6226-3(b) with respect to any adjustments shown on a statement furnished to a RIC or REIT under Proposed Regulation §301.6226-2.

Under §6234(a), a partnership may petition for readjustment within 90 days of the date the FPA is mailed. The proposed regulations coordinate the rules under §6234 so that an election can be made during the time frame provided under §6226 (i.e., within 45 days of the date the FPA is mailed) without cutting off the partnership's right to challenge the adjustments in court within the time frame provided for in §6234. The proposed regulations do this by providing that, while the election under §6226 must be filed within 45 days of the date the FPA is mailed, the filing and furnishing of the statements is not required until 60 days after the adjustments are finally determined. (Proposed Regulation §301.6226-2(b)) The partnership adjustments would become finally determined upon the later of the expiration of the time to file a petition under §6234 or, if a petition is filed, the date when the court's decision becomes final. (Proposed Regulation §301.6226-2(b))

IRS requested comments in a number of areas, and the proposed regulations reserved on these issues. They include how IRS should administer the §6226 requirements in tiered structures (e.g., whether a pass-through partner should be able to flow adjustments through to its owners); what rules would apply when statement described in Proposed Regulation §301.6226.-2 are provided to foreign partners; how to treat under §6226 a direct partner in the partnership that is an estate or trust, or a foreign entity, such as a trust or corporation that may not be liable for U.S. federal income tax with respect to one or more adjustments, but an owner of the direct partner is (or could be) liable for tax with respect to such amount; and whether and how to adjust the outside bases and capital accounts of adjustment year partners if the reviewed year partner whose basis and capital account should have been adjusted is no longer a partner as a result of a liquidating distribution and thus no other partner has succeeded to the liquidating partner's capital account. (Preamble to Proposed Regulation 01/19/2017)

Procedures for Filing an Administrative Adjustment Request

Proposed Regulation §301.6227-1(a) would provide that a partnership may file an administrative adjustment request (AAR) with respect to one or more items of income, gain, loss, deduction, or credit of the partnership and any partner's distributive share thereof for any partnership tax year as determined under §6221 and its regulations. A partnership would have to determine whether the adjustments requested in the AAR result in an imputed underpayment in accordance with Proposed Regulation §301.6227-2(a) for the reviewed year-that is, the tax year to which the adjustments relate. If the requested adjustments result in an imputed underpayment, Proposed Regulation §301.6227-1(a) would provide that the partnership takes the adjustments into account under Proposed Regulation §301.6227-2(b), which requires the partnership to pay the imputed underpayment unless the partnership makes an election under Proposed Regulation §301.6227-2. If the election is made, the reviewed year partners take the adjustments into account in accordance with Proposed Regulation §301.6227-3, which provides rules similar to §6226. Under Proposed Regulation §301.6227-1(a), if the adjustments do not result in an imputed underpayment, the reviewed year partners must take the adjustments into account under the rules of Proposed Regulation §301.6227-3.

Proposed Regulation §301.6227-1(a) would clarify that only a partnership may file an AAR and that a partner may not file an AAR unless the partner is doing so in his capacity as partnership representative for the partnership. In certain cases, a partner that is itself a partnership subject to subchapter C of chapter 63 (that is, the partnership has not elected out of the centralized partnership regime under §6221(b)) may file an AAR in response to the filing of an AAR by the partnership of which it is a partner. (Proposed Regulation §301.6227-3(c)) Proposed Regulation §301.6227-1(a) would clarify that a partnership may not file an AAR solely to provide the partnership an opportunity to change a designation of the partnership representative.

Proposed Regulation §301.6227-1(b) would provide that an AAR may only be filed by a partnership with respect to any partnership tax year for which a partnership return has been filed. A partnership generally may not file an AAR with respect to a partnership tax year more than three years after the later of the date the partnership return for such partnership tax year was filed or the last day for filing such partnership return (determined without regard to extensions). An AAR may not be filed with respect to a partnership tax year after a notice of administrative proceeding with respect to such tax year has been mailed by IRS under §6231.

Under Proposed Regulation §301.6227-1(c)(1), an AAR would have to be filed in accordance with the forms, instructions, and other guidance prescribed by IRS and would have to include any required statements, forms, and schedules. An AAR would have to be signed under penalties of perjury by the partnership representative.

Under Proposed Regulation §301.6227-1(c)(2), a valid AAR would have to include the adjustments requested; any required statements described in Proposed Regulation §301.6227-1(e), including any transmittal with respect to such statements as prescribed in forms, instructions, and other guidance; and any other information prescribed by IRS in forms, instructions or other guidance. Proposed Regulation §301.6227-1(d) would provide that where reviewed year partners are required to take into account adjustments requested in an AAR, the partnership must furnish a copy of the statement filed with IRS to the reviewed year partner to whom the statement relates. If the partnership mails the statement, it would have to be mailed to the current or last address of the reviewed year partner that is known to the partnership. The copy of the statement would have to be furnished to the reviewed year partner on the date the partnership files the AAR with IRS.

Proposed Regulation §301.6227-1(c) describes the statements that would have to be issued to reviewed year partners in the case of an election under Proposed Regulation §301.6227-2(c) or an AAR not resulting in an imputed underpayment under Proposed Regulation §301.6227-2(d). Each statement would have to include:

a. The name and correct TIN of the reviewed year partner;
b. The current or last address of the partner that is known to the partnership;
c. The reviewed year partner's share of items originally reported to the partner (taking into account any adjustments made pursuant to a prior AAR filed under §6227);
d. The reviewed year partner's share of the adjustments requested in the AAR;
e. The date the statement is furnished to the partner; the partnership tax year to which the adjustments relate (the reviewed year); and
f. Any other information required by the forms, instructions, or other guidance prescribed by IRS. (Proposed Regulation §301.6227-1(e))

Under Proposed Regulation §301.6227-1(e)(2), except when a specific partner's share of an item is reflected on an AAR in a specific manner in accordance with the provisions of the partnership agreement and the principles of §704(b), each reviewed year partner's share of an adjustment would have to be determined and reported to the reviewed year partner in the same manner as the item to which the adjustment relates was originally determined and reported on the partnership return for the reviewed year. If the item to which the adjustment relates was not reflected on the partnership's reviewed year return, the reviewed year partners' respective shares of the adjustment would have to be determined and reported to the reviewed year partners in accordance with the manner in which the allocation of the items to which the adjustment relates would have been made under the partnership agreement and subject to the principles of §704(b) in the reviewed year. If the adjustments, as requested in the AAR, allocate items to a specific partner or in a specific manner, the statement would have to reflect the adjustment as allocated in accordance with the AAR.

§6223 states that a partnership and all partners of such partnership will be bound by actions taken by the partnership under subchapter C of chapter 63. Accordingly, Proposed Regulation §301.6227-1(f) would provide that, unless otherwise determined by IRS, a partner's share of the adjustments requested in an AAR as reflected on a statement described in Proposed Regulation §301.6227-1(e) would be binding on the partner. Under Proposed Regulation §301.6227-1(f), a partner would have to treat the adjustments on the partner's return consistently with how the adjustments are treated on the statement that the partnership files with IRS.

Proposed Regulation §301.6227-1(g) would provide that IRS may, within the period provided under §6235, conduct a proceeding with respect to the partnership for the tax year to which the AAR relates and adjust items subject to subchapter C of chapter 63, including the items adjusted in the AAR. In the case of an AAR, IRS may make adjustments with respect to the partnership tax year to which the AAR pertains within three years from the date the AAR is filed. Proposed Regulation §301.6227-1(g) would provide that IRS may re-determine adjustments requested in an AAR, including modifications applied by the partnership to the imputed underpayment. If the partnership adjustments determined by IRS increase any imputed underpayment, the additional amount would be assessed in the same manner and subject to the same restrictions as any other imputed underpayment.

Under Proposed Regulation §301.6227-2(a)(2), in the case of an AAR, a partnership would be able to reduce the imputed underpayment as a result of certain modifications allowed under Proposed Regulation §301.6225-2 that relate to tax-exempt partners, rate modification, modification related to certain passive losses of publicly traded partnerships, modification applicable to qualified investment entities described in §860, and other modifications to the extent allowed under future IRS guidance. The modifications described in Proposed Regulation §301.6227-2 would be the only modifications a partnership could use in an AAR context. Other types of modification-such as modifications under Proposed Regulation §301.6225-2 with respect to amended returns and closing agreements-would not be available in the case of an AAR.

Proposed Regulation §301.6227-2(a)(2)(i) would provide that a partnership does not need to seek IRS approval before modifying an imputed underpayment that results from adjustments requested in an AAR. However, Proposed Regulation §301.6227-2(a)(2)(ii) would provide that modifications to the imputed underpayment resulting from adjustments requested in an AAR can be taken into account by the partnership only if the AAR that is filed includes notification to IRS of the modification, a description of the effect of the modification on the imputed underpayment, an explanation of the basis for such modification, and all necessary documentation to support the partnership's entitlement to such modification. These rules would differ from the modification procedures under §6225, where the imputed underpayment is not modified prior to approval by IRS.

Proposed Regulation §301.6227-2(b)(2)(i) provides that when the adjustments requested in an AAR result in an imputed underpayment, the partnership would have to pay the imputed underpayment (as reduced by modifications meeting the requirements of Proposed Regulation §301.6227-2(a)(2)(ii) at the time the partnership files the AAR, unless the partnership makes the election under Proposed Regulation §301.6227-2(c) to have its reviewed year partners take such adjustments into account. The partnership's payment of the imputed underpayment would be treated as a nondeductible expenditure under §705(a)(2)(B) in accordance with Proposed Regulation §301.6241-4.

Under Proposed Regulation §301.6227-2(b)(2), IRS would be allowed to impose any penalty, addition to tax, and additional amount with respect to such an imputed underpayment in accordance with §6233(a)(3). In the case of any failure to pay an imputed underpayment at the time an AAR is filed, IRS would be permitted to impose any penalty, addition to tax, and additional amount in accordance with §6233(b)(3). Interest on an imputed underpayment would be determined under chapter 67 for the period beginning on the date after the due date of the partnership return for the reviewed year (determined without regard to extension) and ending on the earlier of the date payment of the imputed underpayment is made with the AAR, or the due date of the partnership return for the adjustment year. (§6233(a)(2). In the case of any failure to pay an imputed underpayment before the due date of the partnership return for the adjustment year, any interest would be determined in accordance with §6233(b)(2).

Proposed Regulation §301.6227-2(c) would provide that a partnership may elect to have its reviewed year partners take into account adjustments requested in an AAR that result in an imputed underpayment in lieu of the partnership paying that imputed underpayment. If the partnership makes a valid election under Proposed Regulation §301.6227-2(c), the partnership would no longer be required to pay the imputed underpayment resulting from the adjustments requested in the AAR. Rather, each reviewed year partner would have to take into account its share of such adjustments in accordance with Proposed Regulation §301.6227-3. For these purposes, any modification requested under Proposed Regulation §301.6227-2(a)(2) would be disregarded, and all adjustments requested in the AAR would be taken into account by each reviewed year partner in accordance with Proposed Regulation §301.6227-3.

Adjustments requested in an AAR not resulting in an imputed underpayment. When the adjustments requested in an AAR do not result in an imputed underpayment, the reviewed year partners would have to take into account their shares of such adjustments in accordance with Proposed Regulation §301.6227-3. Proposed Regulation §301.6227-2(d) provides that in that situation, the partnership would be required to furnish statements to the reviewed year partners and file a copy of those statements with IRS in accordance with Proposed Regulation §301.6227-1.

T.D. 9814, 01/18/2017; Regulation §1.721(c)-1T, Regulation §1.721(c)-2T, Regulation §1.721(c)-3T, Regulation §1.721(c)-4T, Regulation §1.721(c)-5T, Regulation §1.721(c)-6T, Regulation §1.721(c)-7T, Regulation §1.6038B-2, Regulation §1.6038B-2T; Preamble to Proposed Regulation 01/18/2017; Proposed Regulation §1.721(c)-1, Proposed Regulation §1.721(c)-2, Proposed Regulation §1.721(c)-3, Proposed Regulation §1.721(c)-4, Proposed Regulation §1.721(c)-5, Proposed Regulation §1.721(c)-6, Proposed Regulation §1.721(c)-7, Proposed Regulation §1.6038B-2.

Temporary regulations that address transfers of appreciated property by U.S. persons to partnerships with foreign partners related to the transferor. The regulations, issued pursuant to IRS's statutory authority grant in §721(c), override the rules providing for nonrecognition of gain on a contribution of property to a partnership in exchange for an interest in the partnership under §721(a) unless the partnership adopts the remedial method and certain other requirements are satisfied. The text of the temporary regulations also serves as the text of contemporaneously issued proposed regulations.

Observation: The new regulations will allow IRS to prevent the transfer of appreciated property to a foreign partner for the purpose of having the foreign partner sell the property and avoid U.S. tax on the gain.

IRS has authority under §721(c) to override the application of the nonrecognition provision of §721(a), which generally provides that no gain or loss is recognized to a partnership or its partners in the case of a contribution of property to the partnership in exchange for an interest in it. Under §721(c), IRS can issue regulations to provide that §721(a) will not apply to gain realized on the transfer of property to a partnership (domestic or foreign) if the gain, when recognized, would be includible in the gross income of a person other than a U.S. person. However, no such regulations have been issued before.

§704(a) and §704(b) provide that a partner's distributive share of income, gain, loss, deduction, or credit is determined under the partnership agreement unless the partnership agreement does not provide rules for such allocation or the allocation does not have substantial economic effect. Under §704(c)(1)(A), a partnership is required to allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution (704(c) allocations).

Regulation §1.704-3(a)(1) provides that the purpose of §704(c) is to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. In addition, partnerships may, but are not required to, revalue partnership property pursuant to Regulation §1.704-1(b)(2)(iv)(f) or Regulation §1.704-1(b)(2)(iv)(s) upon the occurrence of enumerated events, such as the entry of a new partner by contribution.

Section 704(c) allocations must be made using any reasonable method consistent with the purpose of §704(c). (Regulation §1.704-3(a)(1)) One such method is the "remedial allocation method," under which certain distortions caused by the "ceiling rule" (essentially, a limitation on a partnership's ability to allocate income, gain, and deductions among its partners) may be eliminated by making remedial allocations of income, gain, loss, or deduction to the noncontributing partners equal to the full amount of the limitation caused by the ceiling rule, and offsetting those allocations with remedial allocations of income, gain, loss, or deduction to the contributing partner. (Regulation §1.704-3(d)(1))

IRS is aware that certain taxpayers purport to be able to contribute, consistently with §704(b) (dealing with the determination of a partner's distributive share of a partnership's income, gains, losses, deductions, and credits), §704(c), and §482, property to a partnership that allocates the income or gain from the contributed property to related foreign partners that are not subject to U.S. tax. Many of these taxpayers choose a §704(c) method other than the remedial method and/or use valuation techniques that are inconsistent with the arm's length standard.

IRS voiced these concerns in Notice 2015-54, 2015-34 IRB 210 and announced its intent to issue regulations to address them. IRS received comments in response to the Notice, several of which are discussed below.

To address the above concerns, IRS determined that it would exercise its regulatory authority under §721(c) to override the application of §721(a) to gain realized on the transfer of property to a partnership (domestic or foreign) in certain circumstances in which the gain, when recognized, ultimately would be includible in the gross income of a foreign person.

Relevant definitions are set out in Regulation §1.721(c)-1T, including:

a. A "section 721(c) partnership" is a partnership to which a U.S. transferor contributes "section 721(c) property" (below) and, after the contribution and any related transactions, (i) a related foreign person is a direct or indirect partner, and (ii) the U.S. transferor and related persons own (directly or indirectly) more than 80% of the interests in partnership capital, profits, deductions, or losses. (Regulation §1.721(c)-1T(b)(14(i)) The Notice had originally provided a "more than 50%" test.

b. "Section 721(c) property" is property, other than excluded property, with built-in gain that is contributed to a partnership by a U.S. transferor. (Regulation §1.721(c)-1T(b)(15)(i)) Excluded property includes, among things, cash equivalents, securities under §475(c)(2), and an item of tangible property with built-in gain that does not exceed $20,000 or with an adjusted tax basis in excess of book value (built-in loss).

c. "Built-in gain" with respect to an item of property contributed to a partnership is the excess of the book value of the property over the partnership's adjusted tax basis in the property upon the contribution, determined without regard to the application of the gain recognition rule of Regulation §1.721(c)-2T(b). (Regulation §1.721(c)-1T(b)(2))

d. A "U.S. transferor" is a U.S. person (within the meaning of §7701(a)(30)) other than a domestic partnership. (Regulation §1.721(c)-1T(b)(18)(i))

e. A "related person" is a person that is related (within the meaning of §267(b) or §707(b)(1)) to a U.S. transferor. (Regulation §1.721(c)-1T(b)(12))

f. A "related foreign person" is a person that is a related person (other than a partnership) that is not a U.S. person. (Regulation §1.721(c)-1T(b)(11))

g. A "direct or indirect partner" is a person (other than a partnership) that owns an interest in a partnership directly or indirectly through one or more partnerships. (Regulation §1.721(c)-1T(b)(5))

Regulation §1.721(c)-2T provides the general operative rules that override §721(a) nonrecognition of gain upon a contribution of section 721(c) property to a section 721(c) partnership. §721(a) does continue to apply, however, to a direct contribution of section 721(c) property by an "unrelated" U.S.

transferor that does not, with other persons related to it, satisfy the ownership requirement. (Regulation §1.721-2T(b)) In addition, under a de minimis exception, contributions of section 721(c) property will not be subject to immediate gain recognition if the sum of all built-in gain for all section 721(c) property contributed to a section 721(c) partnership during the partnership's tax year does not exceed $1 million. (Regulation §1.721-2T(c))

A look-through rule is provided for identifying a section 721(c) partnership when an upper-tier partnership in which a U.S. transferor is a direct or indirect partner contributes property to a lower-tier partnership. (Regulation §1.721(c)-2T(d)) For purposes of determining if the lower-tier partnership is a section 721(c) partnership, the U.S. transferor will be treated as contributing to the lower-tier partnership its share of the property actually contributed by the upper-tier partnership to the lower-tier partnership. If the lower-tier partnership is a section 721(c) partnership, the upper-tier partnership will generally recognize the entire built-in gain in the section 721(c) property under the general gain recognition rule because the entire property will be section 721(c) property. (Regulation §1.721(c)-2T(d)(1))

Under Regulation §1.721(c)-2T(d)(1), the partnership look-through rule will not apply to a deemed contribution by an "old" partnership to a "new" partnership that occurs as a result of a technical termination of the old partnership. Thus, a technical termination will not cause a non-section 721(c) partnership, in which a U.S. transferor is a direct or indirect partner, to become a section 721(c) partnership.

The gain deferral method, covered at Regulation §1.721(c)-3T, generally must be applied in order to avoid the immediate recognition of gain upon a contribution of section 721(c) property to a section 721(c) partnership.

There are five general requirements for applying the gain deferral method to an item of section 721(c) property:

1. The section 721(c) partnership adopts the remedial allocation method and allocates §704(b) items of income, gain, loss, and deduction with respect to the section 721(c) property in a manner that satisfies the consistent allocation method;

2. The U.S. transferor recognizes gain equal to the remaining built-in gain with respect to the section 721(c) property upon an acceleration event, or an amount of gain equal to a portion of the remaining built-in gain upon a partial acceleration event or certain transfers to foreign corporations described in §367;

3. Procedural and reporting requirements are satisfied;

4. The U.S. transferor extends the period of limitations on assessment of tax (for eight full tax years with respect to the gain realized but not recognized on a gain deferral contribution, for six full tax years with respect to the U.S. transferor's distributive share of all items with respect to the section 721(c) property for the year of contribution and two subsequent years, and for five full tax years with respect to the gain recognized on the contribution of section 721(c) property for which the gain deferral method is not applied if the contribution is made within five partnership tax years following a gain deferral contribution (Regulation §1.721(b)-6T(b)(5)); and

5. The rules for tiered partnerships are satisfied if either the section 721(c) property is an interest in a partnership or the section 721(c) property is described in the partnership look-through rule in Regulation §1.721(c)-2T(d)(1).

The gain deferral method applies on a property-by-property basis. However, IRS noted that separate transactions can be aggregated under §482 for purposes of determining the arm's length pricing of such transactions, as well as for purposes of analysis under multiple other Code or regulation provisions, if the transactions are so interrelated that an aggregate analysis is appropriate. (T.D. 9814)

The temporary regulations also provide special rules for a contribution of section 721(c) property that gives rise to income effectively connected with a U.S. trade or business (ECI property), which is generally subject to immediate gain recognition if the gain deferral method is not applies. Special rules also govern the application of the gain deferral method to certain "anti-churning" property, and IRS sought comments on how to handle a number of issues relating to a section 721(c) partnership's application of the remedial allocation method to §197(f)(9) intangible property. (T.D. 9814)

Regulation §1.721(c)-3T(c)(1) describes the consistent allocation method, which, like the gain deferral method, applies on a property-by-property basis. The consistent allocation method requires a section 721(c) partnership to allocate the same percentage of each book item of income, gain, deduction, and loss "with respect to the section 721(c) property" to the U.S. transferor. Regulation §1.721(c)-3T(c)(2) provides guidance for determining how partnership items are determined to be "with respect to section 721(c) property." In general, a section 721(c) partnership must attribute book income and gain to each property in a consistent manner using any reasonable method that takes into account all the facts and circumstances, and all items of book income and gain attributable to each property will comprise a single class of gross income for purposes of determining the extent to which partnership items of deduction or loss are allocated and apportioned with respect to the section 721(c) property. (Regulation §1.721(c)-3T(c)(2))

The rules for determining the extent to which partnership items of book deduction and loss are considered to be "with respect to" particular section 721(c) property for purposes of applying the consistent allocation method are provided in Regulation §1.721(c)-3T(c)(3). A section 721(c) partnership must allocate and apportion all of its items of deduction, except for interest expense and research and experimental expenditures (R&E), and loss to the class of gross income with respect to each section 721(c) property, applying the principles of Regulation §1.861-8 and Regulation §1.861-8T. The section 721(c) partnership may allocate and apportion its interest expense and R&E using any reasonable method.

The temporary regulations also provide exceptions from the requirement to apply the consistent allocation method with respect to certain book items of a section 721(c) partnership for: (i) certain regulatory allocations (generally allocations, such as those pursuant to a minimum gain chargeback or a partner nonrecourse deduction, where partners generally do not have discretion regarding their application); and (ii) creditable foreign tax expenditures. (Regulation §1.721(c)-3T(c)(4)(ii))

Acceleration events, covered at Regulation §1.721(c)-4T, apply on a property-by-property basis. When an acceleration event occurs with respect to section 721(c) property, remaining built-in gain in the property must be recognized and the gain deferral method no longer applies.

An acceleration event is any event that would reduce the amount of remaining built-in gain that a U.S. transferor would have recognized under the gain deferral method if the event had not occurred or that could defer the recognition of the remaining built-in gain, including the transfer of section 721(c) property via a contribution of the property itself or through a contribution of a partnership interest.

In general, an acceleration event with respect to section 721(c) property occurs when any party fails to comply with a requirement of the gain deferral method with respect to that property. (Regulation §1.721(c)-4T(b)(2)(i)) However, an acceleration event will not occur solely as a result of a failure to comply with a procedural or reporting requirement of the gain deferral method if that failure is not willful and relief is sought under the prescribed procedures. (Regulation §1.721(c)-4T(b)(2)(ii)) In addition, when section 721(c) property is an interest in a partnership, an acceleration event will not occur because of a reduction in remaining built-in gain in the partnership interest as a result of allocations of book items of deduction and loss or tax items of income and gain by that partnership. (Regulation §1.721(c)-4T(b)(3))

The consequences of an acceleration event are that the U.S. transferor must recognize gain in an amount equal to the remaining built-in gain that would have been allocated to the U.S. transferor if the section 721(c) partnership had sold the section 721(c) property immediately before the acceleration event for fair market value. Following the acceleration event, the section 721(c) property will no longer be subject to the gain deferral method, the U.S. transferor generally must make correlative adjustments to its basis in its partnership interest, and the section 721(c) partnership will increase its basis in the section 721(c) property by the amount of gain recognized by the U.S. transferor. (Regulation §1.721(c)-4T(c))

Exceptions to acceleration events are covered in Regulation §1.721(c)-5T, and include the following categories:

1. Termination events, in which case, the gain deferral method ceases to apply to the section 721(c) property; (Regulation §1.721(c)-5T(b))

2. Successor events, in which case the gain deferral method continues to apply to the section 721(c) property but with respect to a successor U.S. transferor or a successor section 721(c) partnership, as applicable; (events are identified at Regulation §1.721(c)-5T(c))

3. Partial acceleration events, in which case, a U.S. transferor recognizes an amount of gain that is less than the full amount of remaining built-in gain in the section 721(c) property and the gain deferral method continues to apply; (Regulation §1.721(c)-5T(d))

4. Transfers described in §367 of section 721(c) property to a foreign corporation, in which case, the gain deferral method ceases to apply and a U.S. transferor recognizes an amount of gain equal to the remaining built-in gain attributable to the portion of the section 721(c) property that is not subject to tax under §367; (Regulation §1.721(c)-5T(e)) and

5. Fully taxable dispositions of a portion of an interest in a section 721(c) partnership, in which case, the gain deferral method continues to apply for the retained portion of the interest. (Regulation §1.721(c)-5T(f))

In general, the temporary regulations employ two principles in applying the gain deferral method to tiered partnerships: first, if the section 721(c) property is an interest in a partnership, the contribution of that partnership interest, and not the indirect contribution of the underlying property of the lower-tier partnership, to a section 721(c) partnership is subject to section 721(c), and the gain deferral method applies to the contribution of the interest; and second, the gain deferral method must also be adopted at all levels in the ownership chain. (T.D. 9814) However, because a number of issues arise in applying the gain deferral method to tiered partnerships, the temporary regulations set out a number of specific additional requirements that must be satisfied in order for the method to apply. (Regulation §1.721(c)-3T)

Procedural and reporting requirements. The procedural and reporting requirements are provided in Regulation §1.721(c)-6T, including the requirements of a U.S. transferor, the information to be reported with respect to related foreign persons and partnerships, the procedural and reporting requirements of a section 721(c) partnership with a §6031 filing obligation, the proper signatory, and relief for certain non-willful failures to comply.

For a U.S. transferor, the reporting requirements include, among other information, the information required to be filed under §6038B. The temporary regulations also adopt the procedures for seeking relief for a failure to meet the reporting requirements of the gain deferral method. (Regulation §1.721(c)-6T(f); Regulation §1.6038B-2T(h))

The temporary regulations require reporting necessary to demonstrate compliance with the gain deferral method. In general, the temporary regulations require a U.S. transferor to report information on a statement included on (or attached to) the Form 8865, Schedule O, Transfer of Property to a Foreign Partnership, which will be revised to reflect the temporary regulations. (T.D. 9814)

A U.S. transferor that contributes section 721(c) property to a domestic section 721(c) partnership in a gain deferral contribution must file a Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships (including Form 8865, Schedule O, Transfer of Property to a Foreign Partnership), with its return for the tax year that includes the date of the gain deferral contribution. (Regulation §1.721(c)-6T(b)(4)) Special rules apply where the section 721(c) property that is subject to the gain deferral method is ECI property. (Regulation §1.721(c)-6T(c)(1))

The U.S. transferor is also required to provide information with respect to related foreign partners and certain section 721(c) partnerships under §6038B and the gain deferral method. This requirement also applies in the case of a partnership in a tiered-partnership structure that applies the gain deferral method. (Regulation §1.721(c)-6T(b)(2)) The U.S. transferor must attach this information to its return.

If the section 721(c) partnership has a reporting obligation under §6031, it also will be required to report certain information under Regulation §1.721(c)-6T(d), but a failure to do so will not constitute an acceleration event to the U.S. transferor. IRS intends to revise Form 1065, Schedule K-1, or its accompanying instructions to describe this required information. Failure to include this information may result in imposition of a penalty. (§6721, §6722)

The temporary regulations require the U.S. transferor to provide certain information on an annual basis with respect to section 721(c) property subject to the gain deferral method, and to attach a Schedule K-1 (Form 8865), Partner's Share of Income, Deductions, Credits, etc., for all related foreign persons that are direct or indirect partners in the section 721(c) partnership (if the partnership does not have a filing obligation under §6031) for the partnership tax year that ends with, or within, the U.S. transferor's tax year. Additional requirements apply in the case of ECI property subject to the gain deferral method.

The U.S. transferor must describe all acceleration, termination, successor, and partial acceleration events that occur with respect to the section 721(c) property during the partnership tax year that ends with, or within, the U.S. transferor's tax year, as well as certain information specific to each event. If the section 721(c) partnership is a foreign partnership, the U.S. transferor must include the information described in Regulation §1.6038-3(g) (contents of information returns required of certain U.S. persons with respect to controlled foreign partnerships), if not already reported elsewhere, without regard to whether the section 721(c) partnership is a controlled foreign partnership or whether the U.S. transferor controlled the section 721(c) partnership. If the U.S. transferor is not a controlling 50% partner (as defined in Regulation §1.6038-3(a)), the U.S. transferor may comply with this requirement by providing only the information described in Regulation §1.6038-3(g)(1). These requirements also apply to a U.S. transferor that is a successor.

If the section 721(c) partnership has a filing obligation under §6031, the partnership must include the information required under Regulation §1.721(c)-6T(b)(2) and Regulation §1.721(c)-6T(b)(3) on the

Schedule K-1 of the U.S. transferor and all related foreign persons that are direct or indirect partners in the section 721(c) partnership. (Regulation §1.721(c)-6T(d)(2))

The temporary regulations are effective on January 18, 2017, but the applicability dates generally relate back to the issuance of the Notice so as to apply to contributions occurring on or after August 6, 2015, and to contributions occurring before August 6, 2015 that result from an entity classification election made under Regulation §301.7701-3 that is filed on or after August 6, 2015. However, any new rules that were first set out in the temporary regulations, including any substantive changes to the rules described in the Notice, apply to contributions occurring on or after January 18, 2017, or to contributions occurring before January 18, 2017 that result from an entity classification election that is filed on or after January 18, 2017. Taxpayers may, however, elect to apply those new rules and substantive changes to the rules described in the Notice to a contribution occurring on or after August 6, 2015.

T.D. 9812, 01/13/2017, Regulation §1.7874-4, Regulation §1.7874-5, Regulation §1.7874-7T, Regulation §1.7874-10T, Preamble to Proposed Regulation 01/13/2017.

Final inversion regulations under §7874 that identify certain stock of a foreign corporation that is disregarded in calculating ownership of the foreign corporation for purposes of determining whether it is a surrogate foreign corporation. The regulations also provide guidance on the effect of transfers of stock of a foreign corporation after the foreign corporation has acquired substantially all of the properties of a domestic corporation or of a trade or business of a domestic partnership. In addition, temporary regulations on the de minimis exception under the disqualified stock rule in the pre-existing temporary regulations. The text of the temporary regulations serves as the text of proposed regulations.

Corporate inversions (also called "expatriation transactions") generally involve a U.S. corporation that engages in a series of transactions with the effect of moving its headquarters from the U.S. to a lower-taxed foreign jurisdiction. The transactions might be effected by the U.S. corporation becoming a wholly owned subsidiary of a foreign corporation (through a merger into the foreign corporation's U.S. subsidiary) or by transferring its assets to the foreign corporation. If the transaction is respected, U.S. tax can be avoided on foreign operations and distributions to the foreign parent, and there are opportunities to reduce income from U.S. operations by payments of fees, interest, and royalties to the foreign entity.

Inversion transactions are generally governed by §7874, under which a foreign corporation is treated as a U.S. corporation for all purposes (i.e., the benefits of being treated as foreign are lost) of the Code where, under a plan or series of related transactions:

1. The foreign corporation completes, after March 4, 2003, the direct or indirect acquisition of substantially all the properties held directly or indirectly by a U.S. corporation;

2. Shareholders of the U.S. Corporation obtain 80% or more of the foreign corporation's stock (by vote or value) by reason of holding their U.S. shares (the "80% test"). (This percentage is termed "the ownership percentage," and the fraction used to calculate the ownership percentage is termed " the ownership fraction"); and

3. The foreign corporation, and corporations connected to it by a 50% chain of ownership, do not have "substantial business activities" in the foreign corporation's country of incorporation or organization when compared to the total business activities of the group. (§7874(b), §7874(a)(2)) "Substantial business activities" means, for this purpose, 25% of the firm's employees, assets, and sales being in the foreign country. (Regulation §1.7874-3)

A separate set of rules applies to inversion transactions where the domestic corporation's shareholders obtain at least 60% but less than 80% of the foreign corporation's stock (the "60% test"). In general, such a foreign corporation is a "surrogate foreign corporation" that gets some, but not all, of the tax benefits associated with being a foreign corporation, and the expatriated entity's "inversion gain" (defined as any income recognized during a 10-year period by reason of the acquisition, not offset by a net operating loss (NOL) or foreign tax credit) is taxed at the maximum corporate rate. (§7874(a)(2)(B)) These rules effectively penalize, but do not prohibit, inversions.

Also, in certain inversions, Regulation §1.367(a)-3(c) may cause a U.S. person that is a shareholder of the domestic parent corporation to recognize gain (but not loss) on the exchange of its stock in the domestic corporation.

In September of 2009, IRS issued Notice 2009-78, 2009-40 IRB 452 (the 2009 Notice), which announced that regulations would be issued under §7874 that would identify certain stock of a foreign corporation that would not be taken into account for purposes of determining the ownership percentage described in §7874(a)(2)(B)(ii).

In January of 2014, IRS issued temporary regulations (the 2014 temporary regulations) that implemented and obsoleted the 2009 Notice and provided guidance with respect to subsequent transfers of stock of a foreign corporation described in §7874(a)(2)(B)(ii).

In September of 2014, IRS issued Notice 2014-52, 2014-42 IRB 712, which announced the intention to issue regulations to address certain transactions structured to avoid the purposes of §7874 and Regulation §1.367(a)-3(c) and certain post-inversion tax avoidance transactions. In November of 2015, IRS issued Notice 2015-79, 2015-49 IRB 775, which announced the intention to issue regulations to address certain additional transactions structured to avoid the purposes of §7874 and Regulation §1.367(a)-3(c) and certain additional post-inversion tax avoidance transactions.

In April of 2016, IRS issued temporary regulations (the 2016 temporary regulations) that address transactions that are structured to avoid the purposes of §7874 and §367 and certain post-inversion tax avoidance transactions.

IRS has now issued final, temporary, and proposed regulations that provide guidance for determining stock ownership as well as rules regarding inversions and related transactions. These rules, and the modifications made by the new guidance, follow.

The 2014 temporary regulations, as modified by the 2016 temporary regulations, provide a rule (the disqualified stock rule) that, subject to a de minimis exception (below), excludes disqualified stock from the denominator of the ownership fraction. In general, disqualified stock is stock of the foreign acquiring corporation that, in a transaction related to the domestic entity acquisition, is transferred in an exchange described in Regulation §1.7874-4T(c)(1)(i) or Regulation §1.7874-4T(c)(1)(ii). However, stock is disqualified stock only to the extent that the transfer of the stock in the exchange increases the fair market value of the assets of the foreign acquiring corporation or decreases the amount of its liabilities (the net asset requirement). The disqualified stock rule thus generally prevents stock of the foreign acquiring corporation that is transferred in certain transactions that increase the net assets of the foreign acquiring corporation from inappropriately increasing the denominator of the ownership fraction and so diluting the ownership percentage.

Disqualified stock includes stock of the foreign acquiring corporation that, in a transaction related to the domestic entity acquisition, is transferred to a person other than the domestic entity in exchange for "nonqualified property." Nonqualified property means (a) cash or cash equivalents, (b) marketable securities, (c) certain obligations, and (d) any other property acquired with a principal purpose of avoiding the purposes of §7874, regardless of whether the transaction involves an indirect transfer of property described in clause (a), (b), or (c).

The final regulations exclude from the definition of nonqualified property an obligation owed by:

1. A member of the expanded affiliated group (EAG), unless the holder of the obligation immediately before the domestic entity acquisition and any related transaction (or its successor) is a member of the EAG after the domestic entity acquisition and all related transactions. (Regulation §1.7874-4(i)(2)(iii)(A))

2. A former domestic entity shareholder or former domestic entity partner of the domestic entity that owns (applying the attribution rules of §318(a) with the modifications described in §304(c)(3)(B)) at least 5% (by vote or value) of the stock of, or partnership interests in, the domestic entity before the domestic entity acquisition. (Regulation §1.7874-4(i)(2)(iii)(B))

3. A person that, before or after the domestic entity acquisition, either owns (applying the attribution rules of §318(a) with the modifications described in §304(c)(3)(B)) at least 5% (by vote or value) of the stock of (or partnership interests in), or is related (within the meaning of §267 or §707(b)) to: (1) a member of the EAG; or (2) a person described in Regulation §1.7874-4(i)(2)(iii)(B), above. (Regulation §1.7874-4(i)(2)(iii)(C)) IRS notes that the anti-abuse rule in §7874(c)(4) may still apply to disregard transfers of stock in exchange for such obligations.

Disqualified stock also generally includes stock of the foreign acquiring corporation that is transferred by a person (the transferor) to another person (the transferee) in exchange for property (the exchanged property) if, pursuant to the same plan (or series of related transactions), the transferee subsequently transfers the stock in exchange for the satisfaction or assumption of one or more obligations associated with the exchanged property (the associated obligation rule).

The final regulations modify the associated obligation rule. The rule should generally apply if, pursuant to the same plan (or series of related transactions), the transferee uses the stock to directly or indirectly satisfy any obligation of the transferee (regardless of whether it is an associated obligation). For example, the rule should apply if the transferee sells the stock and then uses the proceeds to satisfy an amount of an obligation of the transferee equal to the amount of the associated obligation. (Regulation §1.7874-4(c)(1)(ii)(A)) In these cases, the transferee and the foreign acquiring corporation are in an economic position similar to the one in which they would have been had the foreign acquiring corporation assumed the associated obligation, issued stock in exchange for cash, and then used that cash to satisfy the obligation.

In addition, the final regulations generally limit the amount of disqualified stock arising under the associated obligation rule to the proportionate share of obligations associated with the exchanged property that, pursuant to the same plan (or series of related transactions), is not assumed by the foreign acquiring corporation. (Regulation §1.7874-4(c)(1)(ii)(B))

The disqualified stock rule contains a de minimis exception, which generally applies when two requirements are satisfied: (1) the ownership percentage-determined without regard to the application of the disqualified stock rule, the passive assets rule of Regulation §1.7874-7T (the passive assets rule), and the non-ordinary course distribution rule of Regulation §1.7874-10T (the non-ordinary course distribution rule)-must be less than 5% (by vote and value); and (2) after the domestic entity acquisition and all related transactions, former domestic entity shareholders or former domestic entity partners, in the aggregate, must own (applying the attribution rules of §318(a) with the modifications described in §304(c)(3)(B)) less than 5% (by vote and value) of the stock of (or a partnership interest in) any member of the EAG. When the de minimis exception applies, the disqualified stock rule does not apply and, as a result, no stock of the foreign acquiring corporation is excluded from the denominator of the ownership fraction pursuant to the rule.

The passive assets rule and the non-ordinary course distribution rule contain similar de minimis exceptions (three exceptions that are, collectively, the de minimis exceptions). (Regulation §1.7874-7T(c), Regulation §1.7874-10T(d))

The final and temporary regulations modify each of the de minimis exceptions to provide that the second requirement is satisfied if, after the domestic entity acquisition and all related transactions, each former domestic entity shareholder or former domestic entity partner, as applicable, owns (applying the attribution rules of §318(a) with the modifications described in §304(c)(3)(B)) less than 5% (by vote and value) of the stock of (or a partnership interest in) each member of the EAG. (Regulation §1.7874-4(d)(1)(ii), Regulation §1.7874-7T(c)(2), Regulation §1.7874-10T(d)(2)) IRS has determined that limiting the second requirement to consider only the ownership of former domestic entity shareholders or former domestic entity partners (with applicable attribution rules), individually, rather than the ownership of all former domestic entity shareholders or former domestic entity partners, collectively, strikes the appropriate balance between preventing the de minimis exceptions from applying in inappropriate circumstances and addressing the practical difficulties noted in the comment.

The final regulations clarify that stock of the foreign acquiring corporation included in the numerator of the ownership fraction is in all cases also included in the denominator of the fraction.

The definition of nonqualified property is also clarified to provide that an interest in a partnership is nonqualified property only to the extent it is a marketable security or avoidance property.

The final regulations generally apply to domestic entity acquisitions completed on or after September 17, 2009, to the extent described in the 2009 Notice. The final regulations generally apply with respect to the remainder of the proposed rules in the 2014 proposed regulations to domestic entity acquisitions completed on or after January 16, 2014. However, under Regulation §1.7874-4(k), certain rules apply only to domestic entity acquisitions completed on or after the publication of the 2015 Notice or the final regulations, as applicable. Similar to the 2014 temporary regulations, the regulations provide that taxpayers may elect to apply all the rules contained in the final regulations to domestic entity acquisitions completed on or after September 17, 2009, and before January 13, 2017 (transition period), if the taxpayer applies all of the rules consistently to all domestic entity acquisitions completed during the transition period. No inference is intended as to the treatment of transactions under the law before the various applicability dates of the regulations.

T.D. 9806, 12/27/2016; Regulation §1.1291-1, Regulation §1.1291-9, Regulation §1.6038-2, Regulation §1.6046-1.

Final regulations that provide guidance on determining who is an owner of a passive foreign investment company (PFIC), the annual filing requirements for shareholders of PFICs, and statements required to be filed with IRS by persons who are excepted from certain foreign corporation return rules.

A PFIC is any foreign corporation if: (1) at least 75% of its gross income for its tax year is passive, or (2) at least 50% of the assets it held during the year produce passive income or are held for the production of passive income. (§1297(a))

§1291 through §1298 set forth three tax regimes for PFIC shareholders:

1. The excess distribution rules under §1291 (the " §1291 regime"), which impose a special tax and interest charge on a U.S. person that is a shareholder of a PFIC and that receives an "excess distribution" (defined as the extent to which a current year distribution received by a shareholder on PFIC stock exceeds its ratable portion of 125% of the average amount received with respect to the stock during the three preceding years or, if shorter, the shareholder's holding period prior to the tax year) from a PFIC or recognizes gain derived from a disposition of stock in a PFIC that is treated as an excess distribution under §1291(a)(2);

2. §1293 's qualified electing fund (QEF) rules, under which an electing shareholder must currently include in income his share of the PFIC's earnings and profits (with appropriate basis adjustments), and the fund's ordinary income and net capital gain are passed through to the shareholder as ordinary income and long-term capital gain; and

3. §1296 's mark to market (MTM) rules, under which an electing shareholder includes in income each year an amount equal to the excess, if any, of the fair market value (FMV) of the PFIC stock as of the close of the tax year over the shareholder's adjusted basis in the stock, and is allowed a deduction for the lesser of (a) the excess, if any, of the adjusted basis of the PFIC stock over its FMV as of the close of the tax year, or (b) the "unreversed inclusions," as defined, with respect to the PFIC stock. All amounts so included in income or deducted, as well as any gain or loss on the actual sale or disposition of the PFIC stock, are treated as ordinary income or loss.

§6038 and §6046 require certain U.S. persons to file an information return on Form 5471 (Information Return of U.S. Persons with Respect to Certain Foreign Corporations) with respect to their ownership in certain foreign corporations or because they are an officer or director of certain foreign corporations.

In December 2013, IRS issued temporary regulations with respect to PFIC ownership and filing requirements and Form 5471 filing requirements. (T.D. 9650, 12/30/2013) The text of those temporary regulations also served as the text of proposed regulations. (Preamble to Proposed Regulation 12/30/2013)

IRS has now issued final regulations that provide guidance on determining who is an owner of a PFIC, the annual filing requirements for shareholders of PFICs, and statements required to be filed with IRS by persons who are excepted from Form 5471 filing. Highlights of the final regulations include:

a. **Definition of shareholder**. In Notice 2014-28, 2014-18 IRB 990, IRS announced that regulations under §1291 would provide that a U.S. person that owns stock of a PFIC through a tax-exempt organization or account is not treated as a shareholder of the PFIC with respect to the stock. That Notice said that the application of the PFIC rules to a U.S. person treated as owning stock of a PFIC through a tax-exempt organization or account (as described in Regulation §1.1298-1(c)(1)) would be inconsistent with the tax policies underlying the PFIC rules and the treatment of tax-exempt organizations and accounts. For example, applying the PFIC rules to a U.S. person that owns stock of a PFIC through an individual retirement account (IRA) described in §408(a) would be inconsistent with the principle of deferred taxation provided by IRAs.

   Under new Regulation §1.1291-1(e)(2), a U.S. person is not treated as a shareholder of a PFIC to the extent the person owns PFIC stock through a tax-exempt organization or account described in Regulation §1.1298-1(c)(1).

b. **Definition of indirect shareholder**. Regulation §1.1291-1T(b)(8)(ii)(A) provided that a U.S. person who directly or indirectly owns 50% or more in value of the stock of a foreign corporation that is not a PFIC is considered to own a proportionate amount (by value) of any stock (including PFIC stock) owned directly or indirectly by the foreign corporation. Thus, for example, if a U.S. person owned 100% of the shares of FC, a foreign corporation that is not itself a PFIC but that owns 50 shares of a PFIC, the U.S. person would be treated as indirectly owning the 50 PFIC shares.

Regulation §1.1291-1T(b)(8)(ii)(C) provided that, if stock of a "section 1291 fund" was not treated as owned indirectly by a U.S. person under the other attribution rules provided in the proposed regulations, but would be treated as owned by a U.S. person if the ownership rule of Regulation §1.1291-1T(b)(8)(ii)(A) applied to domestic corporations (in addition to foreign corporations), then the stock of the section 1291 fund would be considered as owned by such U.S. person. A PFIC is a section 1291 fund with respect to a shareholder unless the PFIC is a "pedigreed QEF" with respect to the shareholder or a §1296 election is in effect with respect to the shareholder. (Regulation §1.1291-1(b)(2)(v))

The literal language of Regulation §1.1291-1T(b)(8)(ii)(C) could have been interpreted to create overlapping ownership by two or more U.S. persons in the same stock of a section 1291 fund. IRS says that such an outcome is inconsistent with the intended purpose of the rule to attribute stock through a domestic C corporation in certain circumstances if, absent such attribution, the stock of a PFIC would not be treated as owned by any U.S. person.

To address this concern, the final regulations include a non-duplication rule. Regulation §1.1291-1(b)(8)(ii)(C)(1) provides that, solely for purposes of determining whether a person owns 50% or more in value of the stock of a foreign corporation that is not a PFIC under Regulation §1.1291-1(b)(8)(ii)(A), a person who directly or indirectly owns 50% or more in value of the stock of a domestic corporation is considered to own a proportionate amount (by value) of any stock owned directly or indirectly by the domestic corporation. However, the non-duplication rule in Regulation §1.1291-1(b)(8)(ii)(C)(2) states that a U.S. person will not be treated, as a result of applying Regulation §1.1291-1(b)(8)(ii)(C)(1), as owning (other than for purposes of determining whether a person satisfies the ownership threshold of Regulation §1.1291-1(b)(8)(ii)(A)) stock of a PFIC that is directly owned or considered owned indirectly under Regulation §1.1291-1(b)(8) by another U.S. person (determined without regard to Regulation §1.1291-1(b)(8)(ii)(C)(1)).

c. **Exceptions to §1298(f) reporting requirements.** The temporary regulations provided rules regarding the Form 8621 (Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund) reporting requirements under §1298(f), that are applicable to a U.S. person that is a shareholder of a PFIC. (Regulation §1.1298-1T) Regulation §1.1298-1T(b) provided the §1298(f) annual reporting requirements generally applicable to U.S. persons. Regulation §1.1298-1T(c) set forth exceptions to reporting for certain shareholders.

The final regulations do not make significant changes to the reporting requirements. (Regulation §1.1298-1(b)) But they do add to and make some changes to the exceptions that had been in Regulation §1.1298-1T(c), including the following:

1. **Marked-to-market stock**. The final regulations, in accordance with Notice 2014-51, 2014-40 IRB 594, add Regulation §1.1298-1(c)(3), which provides that U.S. persons that own PFIC stock that is marked to market under a non- §1296 MTM provision are not subject to §1298(f) reporting unless they are subject to §1291 under the coordination rule in Regulation §1.1291-1(c)(4)(ii). Generally, under Regulation §1.1291-1(c)(4)(ii), when a U.S. person's PFIC stock is marked to market under a non- §1296 MTM provision in a tax year after the year in which the U.S. person acquired the stock, the U.S. person is subject to §1291 for the first tax year in which the U.S. person marks to market the PFIC stock. Thus, the U.S. person is subject to §1291 with respect to any unrealized gain in the stock as of the last day of the first tax year in which the stock is marked to market, as if the person disposed of the stock on that day.

Under Regulation §1.1298-1(c)(2), a shareholder generally is not required to file Form 8621 with respect to a section 1291 fund when the shareholder is not treated as receiving an excess distribution (or recognizing gain treated as an excess distribution) with respect to the section 1291 fund stock, and, as of the last day of the shareholder's tax year, the value of all PFIC stock considered owned by the shareholder does not exceed $25,000 (or $50,000 for shareholders that file a joint return).

Also consistent with Notice 2014-51, the final regulations add Regulation §1.1298-1(c)(2)(ii)(C), pursuant to which a U.S. person's PFIC stock that is marked to market under a non- §1296 MTM provision is not taken into account in determining whether the person qualifies for the exceptions from §1298(f) reporting set forth under Regulation §1.1298-1(c)(2), provided that the rules of Regulation §1.1296-1(i)(2) and Regulation §1.1296-1(i)(3) do not apply with respect to the PFIC stock pursuant to Regulation §1.1291-1(c)(4)(ii) for the tax year.

2. **Exception for certain domestic partnerships**. A tax-exempt organization is subject to §1298(f) reporting with respect to PFIC stock under Regulation §1.1298-1(c)(1) only if the income derived by the organization with respect to the PFIC stock would be taxable to the organization under subchapter F of the Code. However, under the temporary regulations, a domestic partnership (such as a domestic partnership that exclusively pools the funds of tax-exempt organizations to invest in PFICs) was required to file a Form 8621 with respect to PFIC stock even when none of its partners are subject to the PFIC rules with respect to the PFIC stock.

IRS said that requiring reporting under §1298(f) by a domestic partnership when none of its direct and indirect owners are subject to the PFIC rules may result in undue compliance costs and burdens. Accordingly, consistent with the exception in Regulation §1.1298-1(c)(1), the final regulations provide, in Regulation §1.1298-1(c)(6), an exemption from §1298(f) reporting for a domestic partnership with respect to an interest in a PFIC for a tax year when none of its direct or indirect partners are required to file Form 8621 (or successor form) with respect to the PFIC interest under §1298(f) because the partners are not subject to the PFIC rules.

However, a domestic partnership is not exempt from filing Form 8621 under Regulation §1.1298-1(c)(6) with respect to stock it holds in a section 1291 fund when some or all of its partners are exempt from filing Form 8621 with respect to that stock but otherwise would be subject to tax on distributions on, or dispositions of, that stock. (T.D. 9806, 12/27/2016)

a. **Manner of filing Form 8621.** Regulation §1.1298-1(d) generally provides that a U.S. person required to file Form 8621 under §1298(f) with respect to a PFIC for a tax year must attach the form to the person's U.S. income tax return (or information return, if applicable) for the relevant tax year. The instructions for Form 8621 further provide that a U.S. person who is required to file Form 8621 for a tax year in which the person does not file an income tax return (or other return) must send the Form 8621 to IRS at a mailing addressed designated in the instructions.

   Regulation §1.1298-1(d) states that a U.S. person that is not otherwise required to file a U.S. income tax return must file the Form 8621 (or successor form) in accordance with the instructions for the form.

b. **Statements that must be filed by persons excepted from Form 5471 filing.** §6038 may require more than one person to report information about the same foreign corporation for the same period. In that case, previously issued regulations allow two or more taxpayers to make a joint information return, to be filed by one of the persons. (Regulation §1.6038-2(j)(1))

The final regulations provide that any U.S. person required to furnish information under §6038, who does not do so by reason of the provisions of Regulation §1.6038-2(j)(1), must file a statement with his income tax return indicating that such requirement has been (or will be) satisfied and identifying the return with which the information was or will be filed and the place of filing. (Regulation §1.6038-2(j)(3))

The final regulations also provide that a U.S. citizen or resident who is required to file any item of Form 5471 information with respect to a foreign corporation of which he is an officer or director may, if such item of information is furnished by another person having an equal or greater stock interest (measured in terms of either the total combined voting power of all classes of stock of the foreign corporation entitled to vote or the total value of the stock of the foreign corporation) in such foreign corporation, satisfy such requirement by filing a statement with his return on Form 5471 indicating that such requirement has been satisfied and identifying the return in which such item of information was included. This provision does not apply to persons excepted from filing a return under the indirect ownership rules in Regulation §1.6046-1(e)(4). (Regulation §1.6046-1(e)(5))

The new regulations obsolete Notice 2014-28 and Notice 2014-51.

Except as provided in the next sentence, the regulations apply to tax years of shareholders that end on or after December 31, 2013 (i.e., the date that the 2013 temporary regulations were published). (Regulation §1.1291-1(j)(3), Regulation §1.1291-9(k)(3), Regulation §1.1298-1(h)) The Form 5471 rules apply to returns filed on or after December 31, 2013. (Regulation §1.6038-2(m), Regulation §1.6046-1(l)(3))

T.D. 9805, 12/16/2016; Regulation §1.355-8T; Preamble to Proposed Regulation 12/16/2016; Proposed Regulation §1.355-8.

Temporary regulations that set out rules under §355(e) and §355(f), which provide exceptions to the general §355 rule that spin-offs of controlled corporations are tax-free. The text of the temporary regulations also serves as the text of proposed regulations.

§355(a) generally provides that if a distributing corporation (Distributing) distributes stock or securities of a controlled corporation (Controlled) to Distributing's shareholders or security holders and certain requirements are met, no gain or loss is recognized by (and no amount is includible in the income of) Distributing's shareholders or security holders upon their receipt of the Controlled stock. §355(c) generally provides that Distributing does not recognize gain or loss on any distribution of qualified property to which §355 (or so much of §356 as relates to §355) applies.

Similar rules under §361(c) apply in the case of a divisive reorganization under §368(a)(1)(D).

§355(e) provides an exception to the rule of §355(a). §355(e) requires Distributing to recognize gain on the distribution of Controlled if, pursuant to a plan or series of related transactions (a Plan), one or more persons acquire a 50% or greater interest in either Distributing or Corporation (a Planned 50-percent Acquisition). Regulation §1.355-7 provides additional guidance on the meaning of a Plan.

Under §355(e)(2)(C), the existence of a purported Plan that includes a Planned 50-percent Acquisition will not prevent Controlled stock or securities from being treated as qualified property for purposes of §355(c)(2) or §361(c)(2) if, immediately after the completion of such Plan, Distributing and Controlled are members of a single affiliated group, as defined in §1504 without regard to §1504(b) (an Expanded Affiliated Group or EAG). As a result, §355(e) generally does not apply to a distribution between members of the same EAG unless the distribution precedes a distribution of Controlled stock or securities outside of the EAG (an External Distribution) so that Controlled and Distributing are not members of the same EAG after completion of the Plan.

§355(f) provides that, except as provided in regulations, §355 (or so much of §356 as relates to §355) does not apply to the distribution of stock from one member of an affiliated group (as defined in §1504(a)) to another member of the group if the distribution is part of a Plan that includes a Planned 50-percent Acquisition and is not described in §355(e)(2)(C). §355(f) is intended to provide a benefit to such an affiliated group by effectively ensuring that the group recognizes §355(e) gain only once, rather than at multiple levels. In addition, application of §355(f) may eliminate duplicated loss, in some cases. (T.D. 9805, 12/16/2016)

§355(e)(4)(D) provides that, for purposes of §355(e), "any reference to a controlled corporation or a distributing corporation shall include a reference to any predecessor or successor of such corporation."

In 2004, IRS issued proposed regulations with respect to §355(e) and §355(f) (the proposed regulations). See Preamble to Proposed Regulation 11/19/2004.

After considering comments received on the proposed regulations, temporary regulations that largely adopt the rules of the proposed regulations, with modifications.

Predecessor of Distributing. §355(e) does not provide a definition of a predecessor or successor of Distributing or Controlled.

The proposed regulations generally defined a Predecessor of Distributing (POD) as a corporation that transferred its property in a transaction to which §381(a) applies (§381 transaction) to Distributing (a combining transfer), but only if Distributing then transferred some, but not all, of the property acquired in the combining transfer to Controlled in a transferred basis transaction before the distribution of Controlled's stock or securities (a separating transfer). Under the proposed regulations, no corporation could have been a predecessor of a POD. (Proposed Regulation §1.355-8(b)(1))

Under the proposed regulations, the definition of a POD was not tied to the existence of a Plan. Accordingly, a combining transfer and a separating transfer would be taken into account in identifying a POD even if neither transfer was part of a Plan; as a result, taxpayers would have been required to track the assets of any potential POD for an unlimited period prior to the distribution. In addition, once a POD had been identified, it would have been necessary to determine whether the distribution and any acquisitions (deemed or actual) of stock of the POD were part of a Plan, although the proposed regulations included no guidance relating to whether acquisitions of the stock of a POD and the distribution were part of a Plan. (T.D. 9805, 12/16/2016)

The temporary regulations generally broaden the scope of the definition of a PDF, and also modify the definition to cover "synthetic" spinoffs. The temporary regulations change the aspect of the definition of a POD that pulled a corporation into that definition without regard to whether the combining transfer or separating transfer were part of a Plan. The temporary regulations provide a general rule that references in Regulation §1.355-7 to Distributing or Controlled are treated as references to a POD, POC, or Successor of Distributing or Controlled, as the context may require. Further, a reference to a distribution generally includes a reference to a distribution and other related pre-distribution transactions that together effect a division of the assets of a POD.

However, under the temporary regulations, special rules apply with regard to the actions taken into account in determining whether a 50-percent acquisition of a POD occurs as part of Plan. Although a 50-percent acquisition of a POD may occur contemporaneously with a distribution made by Distributing, the acquisition and distribution might occur as part of a Plan of the POD, but without the participation (or even the knowledge) of Distributing. Because Distributing would be the corporation that could recognize §355(e) gain, IRS has determined that it is not appropriate to apply the rules of Regulation §1.355-7 by imputing to Distributing the actions of a POD or its shareholders. Accordingly, the temporary regulations provide that any agreement, understanding, arrangement, or substantial negotiations with regard to the acquisition of a POD is analyzed under Regulation §1.355-7 by taking into account the actions of officers or directors of Distributing or Controlled, controlling shareholders of Distributing or Controlled, or a person acting with the implicit or explicit permission of one of those parties. (Regulation §1.355-8T(a)(4)(ii))

IRS was also concerned that the proposed regulations did not cover under §355(e) a variety of pre-distribution transactions that taxpayers could use to achieve results substantially similar to a combining transfer and separating transfer. For example, a corporation could transfer some, but not all, of its assets to Distributing in a §351 exchange, with those assets ultimately being held by Controlled when its stock is distributed by Distributing. Under the proposed regulations, POD status would not attach to the transferor because the division of the transferor's assets would be accomplished using a §351 exchange and not in a §381 transaction (that is, a combining transfer). IRS refers to this class of transaction as a "synthetic spin-off."

The proposed regulations defined a POD narrowly, so that a corporation that transferred some of its assets to Controlled would be a POD only if it first transferred those assets to Distributing in a §381 transaction. To achieve the goal of applying §355(e) to synthetic spin-offs more effectively, the temporary regulations both broaden and limit the scope of the definition of a POD. The temporary regulations eliminate the formalistic requirements of a combining transfer followed by a separating transfer and generally identify as a POD any corporation whose assets are divided as part of a Plan as a result of some but not all of those assets being transferred to Controlled without the recognition of all of the built-in gain on the transferred assets. No specific transactional form is required with regard to the transfer(s) of assets to Controlled, although such transfers must be made as part of a Plan. Thus, Distributing may recognize §355(e) gain on a distribution of Controlled stock if Controlled acquired assets of any corporation identified as a POD, and the POD experiences a Planned 50-percent Acquisition of its stock. (T.D. 9805, 12/16/2016)

The definition of POD in the temporary regulations focuses on the division of property of any corporation other than Distributing or Controlled (a Potential Predecessor) as part of a Plan. Certain property of a Potential Predecessor (Relevant Property) is required to be tracked for the purpose of determining whether a division of the Potential Predecessor's property has occurred. Relevant Property is defined as any property held, directly or indirectly, by the Potential Predecessor at any point during the Plan Period. The Plan Period, in turn, is defined as the period that ends immediately after the distribution and begins on the earliest date on which any pre-distribution step that is part of the Plan is agreed to or understood, arranged, or substantially negotiated by one or more officers or directors acting on behalf of Distributing or Controlled, by controlling shareholders of Distributing or Controlled, or by another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders. The temporary regulations generally do not treat as Relevant Property any property of a Potential Predecessor that was held directly or indirectly by Distributing or Controlled before a Plan existed. (Regulation §1.355-8T(b))

To alleviate the burden involved in tracking Relevant Property, the temporary regulations provide that only direct or indirect transfers of Relevant Property (including Controlled stock) by Potential Predecessor to Distributing (or to a POD) that occur as part of a Plan are relevant in determining whether a Potential Predecessor is treated as a POD or a predecessor of a POD. (Regulation §1.355-8T(b)(1))

Predecessor of Controlled. The temporary regulations, adopting the definition in the proposed regulations, define a Predecessor of Controlled (POC) as a corporation that transferred its assets to

Controlled in a §381 transaction before the distribution. No corporation could have been a predecessor of a POC. (Proposed Regulation §1.355-8(b)(2); Regulation §1.355-8T(c)(1))

Successor of Distributing and Controlled. The temporary regulations, adopting the definition in the proposed regulations, define a Successor of Distributing or Controlled as a corporation to which Distributing or Controlled, respectively, transferred its assets in a §381 transaction after the distribution (a Successor Transaction). Subsequent acquisitions of stock of the Successor are treated as acquisitions of Distributing (and any PODs). (Proposed Regulation §1.355-8(c); Regulation §1.355-8T(c)(2))

Limitations on gain recognition. Generally, if there is a Planned 50-percent Acquisition of Distributing (or a POD), Controlled, or their Successors, Code Sec 355(e) requires Distributing to recognize the full amount of the built-in gain in the Controlled stock on the date of the distribution under §355(c)(2) or §361(c)(2), as applicable.

The proposed regulations provided two gain limitation rules limiting the amount of gain that Distributing must recognize in certain cases in which there was a POD and a third gain limitation rule providing an overall limitation on Distributing's gain. (Proposed Regulation §1.355-8(e))

The first gain limitation rule applied when there was a planned 50-percent acquisition of one or more PODs. In those cases, the calculation of the §355(e) gain focused on assets of the POD(s) that were transferred to Controlled and any Controlled stock transferred by the POD(s) to Distributing. the proposed regulations limited the §355(e) gain recognized by Distributing to the amount of gain, if any, that any PODs would have recognized if, immediately before the distribution each POD had (1) transferred the property that was transferred to Controlled (and any stock of Controlled that the POD transferred to Distributing) to a newly-formed, wholly-owned corporation solely for stock of such corporation in an exchange to which §351 applied (§351 exchange), and (2) then sold the stock of that corporation to an unrelated person in exchange for cash equal to its fair market value. (Proposed Regulation §1.355-8(e)(2))

The temporary regulations make several modifications to the gain recognition limit rules that had been contained in Proposed Regulation §1.355-8(e)(2). And, the temporary regulations create new additional limitations on the recognition of gain. (Regulation §1.355-8T(e)(2))

Special rule for affiliated groups. §355(e)(2)(C) provides that §355(e) does not apply to a distribution between members of an EAG if, immediately after completion of the Plan, Distributing and Controlled both remain members of the same EAG.

The proposed regulations provided that, for purposes of §355(e)(2)(C), a POD or POC that was a member of the same EAG as Distributing or Controlled (as relevant) at the time of the §381 transaction would be treated as continuing in existence within the EAG following its transfer of property to Distributing or Controlled in the transaction. Similarly, Distributing or Controlled would be treated as continuing in existence following a transfer of property to a Successor that was a member of the same EAG. (Proposed Regulation §1.355-8(f))

Without this rule, for example, because a POD that was a historic member of the EAG would not continue to exist for Federal income tax purposes after transferring property to Distributing in a combining transfer, §355(e)(2)(C) would not prevent §355(e) from applying to a Planned 50-percent Acquisition of the stock of a POD, even if Distributing and Controlled remained members of the same EAG immediately after completion of the Plan. (T.D. 9805, 12/16/2016)

§355(f). §355(e)(2)(C) provides that §355(e) does not apply to an Internal Distribution if, immediately after the Plan, Distributing and Controlled remain members of the same EAG. Also, §355(f) prevents

§355 from applying to an Internal Distribution if §355(e) would otherwise apply to such distribution (that is, if after the Plan, Controlled or a lower-tier Distributing is not a member of the affiliated group as a result of an External Distribution). Because §355 would not apply, the Internal Distribution would be taxable, and the shareholder or security holder would take the Controlled stock or securities with a fair market value basis under §301(d). Upon the subsequent External Distribution, there typically no longer would be built-in gain in the Controlled stock or securities to result in additional §355(e) gain.

IRS has determined that the application of §355(f) may frustrate the policy underlying the first and second gain limitation rules of the temporary regulations in certain cases. Accordingly, the temporary regulations provide that §355(f) does not apply if there is a Planned 50-percent Acquisition of the stock of a predecessor of a lower-tier Distributing but not of the stock of the lower-tier Distributing or Controlled. As a result, §355(e), including the first and second gain limitation rules in these temporary regulations, applies to the Internal Distribution. (Regulation §1.355-8T(g))

The temporary regulations apply to distributions that occur after January 18, 2017. However, they do not apply to a distribution that is: (1) made pursuant to a binding agreement in effect on or before December 16, 2016 and at all times thereafter, (2) described in a ruling request submitted to IRS on or before December 16, 2016 for a transaction that is not modified after such date, or (3) described on or before December 16, 2016 in a public announcement or in a filing with the Securities and Exchange Commission.

In addition, Distributing and any affiliated group of which it is a member may consistently apply these regulations in their entirety to any distribution occurring after November 22, 2004. Taxpayers that do so must consistently apply the temporary regulations in their entirety to all distributions occurring after November 22, 2004 that are part of the same Plan. (Regulation §1.355-8T(i))

T.D. 9803, 12/15/2016; Regulation §1.367(a)-1, Regulation §1.367(a)-2, Regulation §1.367(a)-3, Regulation §1.367(a)-4, Regulation §1.367(a)-6, Regulation §1.367(a)-7, Regulation §1.367(a)-8, Regulation §1.367(d)-1, Regulation §1.367(e)-2, Regulation §1.6038B-1.

Final regulations under §367 and §6038B relating to certain transfers of property by U.S. persons to foreign corporations in nonrecognition transactions. The final regulations eliminate the foreign goodwill exception and limit the scope of property that is eligible for the active trade or business (ATB) exception, thus subjecting more transfers to current gain recognition under §367(a)(1) or the deemed distribution rule for intangibles under §367(d).

Under §367(a)(1), if a U.S. person transfers property to a foreign corporation in connection with an exchange described in §332, §351, §354, §356, or §361, then the foreign corporation generally is not considered a corporation for purposes of determining gain on the transfer. As a result of the §367(a)(1) rule, transfers of property to a foreign corporation that would otherwise be tax-free are treated as taxable exchanges.

However, there are a number of exceptions to the §367(a)(1) rule. §367(a)(3)(A) states that, except as otherwise provided in regulations, the §367(a)(1) rule will not apply to any property transferred to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside of the U.S. (the active trade or business, or ATB exception). However, certain property is not eligible for the ATB exception, including (i) property described in §1221(a)(1) or §1221(a)(3) (relating to inventory and copyrights, etc.); (ii) installment obligations, accounts receivable, or similar property; (iii) foreign currency or other property denominated in foreign currency; (iv) intangible property within the meaning of §936(h)(3)(B) ; and (v) property with respect to which the U.S. transferor is a lessor at the time of the transfer, unless the foreign corporation was the lessee.

The §367(a)(1) rule also will not apply to an outbound transfer of any property that IRS, in order to carry out the purposes of §367(a), designates by Regulation (§367(a)(6))

§367(d), sometimes referred to as the "disposition rule," provides special rules for outbound transfer of intangibles. Except as provided in regulations, under §367(d)(1), if a U.S. transferor transfers any intangible property (within the meaning of §936(h)(3)(B) -generally, patents, copyrights, trademarks, methods, and other similar items with substantial value independent of the services of any individual)-to a foreign corporation in an exchange described in §351 or §361, the U.S. transferor is treated as having sold the property in exchange for payments that are contingent upon the productivity, use, or disposition of the property, and as receiving amounts that reasonably reflect what would have been received annually in the form of such payments over the shorter of the property's useful life (§367(d)(2)(A)(ii)(I)) or 20 years (Regulation §1.367(d)-1T(c)(3)), or in the case of a disposition of the intangible property following such transfer, at the time of the disposition. (§367(d)(2)(A)(ii)(II)) These amounts must be commensurate with the income attributable to the intangible.

Under the "foreign goodwill exception," the transfer of foreign goodwill or going concern value is excepted from the disposition rule. Former Regulation §1.367(a)-1T(d)(5)(iii) defined foreign goodwill or going concern value as the residual value of a business operation conducted outside of the U.S. after all other tangible and intangible assets had been identified and valued (and which included the right to use a corporate name in a foreign country). This rule effectively originated from legislative history underlying §367 -in general, a legislative expectation that the transfer of foreign goodwill or going concern value developed by a foreign branch to a foreign corporation was unlikely to result in abuse of the U.S. tax system. (H.R. Rep. No. 98-432, pt. 2, at 1317-19 (1984))

On May of 1986, IRS issued temporary regulations under §367 and §6038B (the 1986 temporary regulations). In September of 2015, IRS issued proposed regulations on certain transfers of property by U.S. persons to foreign corporations in §367 nonrecognition transactions (2015 proposed regulations. The 2015 proposed regulations generally provided five substantive changes from the 1986 temporary regulations:

1. Eliminating the favorable treatment for foreign goodwill and going concern value by narrowing the scope of the active trade or business exception under §367(a)(3) (i.e., the ATB exception) and eliminating the exception under former Regulation §1.367(d)-1T(b) that provided that foreign goodwill and going concern value were not subject to §367(d);

2. Allowing taxpayers to apply §367(d) to certain property that otherwise would be subject to §367(a);

3. Removing the 20-year limitation on useful life for purposes of §367(d) under former Regulation §1.367(d)-1T(c)(3);

4. Removing the exception under former Regulation §1.367(a)-5T(d)(2) that allowed certain property denominated in foreign currency to qualify for the ATB exception; and

5. Changing the valuation rules under Regulation §1.367(a)-1T to better coordinate the regulations under §367 and §482 (including temporary regulations under §482 issued with the 2015 proposed regulations.

Although minor wording changes have been made to certain aspects of the 1986 temporary regulations, the final regulations are not intended to be interpreted as making substantive changes to these regulations.

The final regulations eliminate the favorable treatment of foreign goodwill and going concern value contained in the 1986 temporary regulations. IRS determined that the final regulations are consistent with intent of Congress and the authority granted to IRS under §367, based on the fact that the Code does not refer to foreign goodwill and going concern value, and the determination that the favorable treatment of foreign goodwill and going concern value contravenes the policy that income generally should be recognized with respect to transfers of §936 intangibles. IRS reasoned that the premise of the expectation noted in the legislative history that an exception to recognition treatment would apply to foreign goodwill and going concern value-namely, that outbound transfers of foreign goodwill and going concern value would not lead to abuse-was inconsistent with IRS's experience in administering §367(d), and consequently no longer supported such an exception. Rather, IRS has found over the past three decades that this favorable treatment has interfered with the application of the general rule in §367(d) that requires income recognition upon the outbound transfer of §936 intangibles, due to the inherent difficulty of distinguishing value attributable to goodwill and going concern value from value attributable to enumerated §936 intangibles, coupled with taxpayer efforts to maximize the value allocated to goodwill and going concern value.

IRS also determined that it was appropriate to retain the approach provided in the 2015 proposed regulations, which allows taxpayers to apply §367(d) to certain property that otherwise would be taxed under §367(a) but which continues to require taxpayers to apply §367(d) to all property described in §936(h)(3)(B). Because the identification of items that are neither explicitly listed in §936(h)(3)(B)(i) through §936(h)(3)(B)(v) nor explicitly listed as potentially qualifying for the ATB exception, generally will require a case-by-case functional and factual analysis, the final regulations do not address the characterization of such items as similar items (within the meaning of §936(h)(3)(B)(vi)) or as something else. In general, potential rules under §367 for identifying and valuing transferred property are beyond the scope of the final regulations.

Under the final regulations, in cases where the useful life of the transferred property is indefinite or is reasonably anticipated to exceed 20 years, taxpayers may, in the year of transfer, choose to take into account §367(d) inclusions only during the 20-year period beginning with the first year in which the U.S transferor takes into account income under §367(d). (Regulation §1.367(d)-1(c)(3)(ii)) The requirement that inclusions during the limited 20-year period begin in the first year in which in which the U.S transferor takes into account income under §367(d) reflects the possibility of delays between the year the intangible property is transferred and the first year in which exploitation of the transferred property results in taxable income being earned by the transferee and included under §367(d) by the transferor. (T.D. 9803, 12/15/2016)

The final regulations specifically require a taxpayer that chooses to limit §367(d) inclusions to a 20-year period to include, during that period, amounts that reasonably reflect amounts that, in the absence of the limitation, would be required to be included over the useful life of the transferred property following the end of the 20-year period. This requirement is consistent with the requirement in §367(d) to include amounts that are commensurate with the income attributable to the transferred intangible during its full useful life, without limitation. (T.D. 9803, 12/15/2016)

The final regulations provide that, if a taxpayer chooses to limit inclusions under §367(d) to a 20-year period, no adjustments will be made for tax years beginning after the conclusion of the 20-year period. Thus, after the statute of limitations expires for tax years during the 20-year period, a taxpayer will have no further §367(d) inclusions as a result of IRS's examination of tax years that begin after the end of the 20-year period. However, consistent with the commensurate-with-income principle, for purposes of determining whether income inclusions during the 20-year period are commensurate with the income attributable to the transferred property, and whether adjustments should be made for tax years during that period while the statute of limitations for such tax years is open, IRS may take into account information with respect to tax years after that period, such as the income attributable to the transferred property during those later years. (Regulation §1.367(d)-1(c)(3)(ii))

The final regulations revise the definition of useful life to provide that useful life includes the entire period during which exploitation of the transferred intangible property is reasonably anticipated to affect the determination of taxable income, in order to appropriately account for the fact that exploitation of intangible property can result in both revenue increases and cost decreases.

Former Regulation §1.367(a)-5T(d)(2) generally provided that §367(a)(1) did not apply to certain transfers of property denominated in the currency of the country in which the transferee foreign corporation was organized; the 2015 proposed regulations eliminated this regulatory exception from the general rule in §367(a)(3)(B)(iii) that turns off the ATB exception for such property. Regulation §1.367(a)-2(c)(3) of the final regulations (which corresponds to former Regulation §1.367(a)-5T(d)(2)) reflects amendments that increase consistency with the rules in §987 and §988. In particular, the terms "foreign currency" and "property denominated in foreign currency" are no longer used. Rather, Regulation §1.367(a)-2(c)(3) is revised to refer to nonfunctional currency and other property that gives rise to a §988 transaction of a taxpayer described in §988(c)(1)(B), or that would give rise to such a §988 transaction if it were acquired, accrued, or entered into directly by the taxpayer. IRS considers that these modifications do not substantially change the scope of property subject to the rule at former Regulation §1.367(a)-5T(d)(2).

The final regulations generally apply for transfers occurring on or after September 14, 2015 (i.e., the proposed applicability date under the 2015 proposed regulations). However, former Regulation §1.367(a)-5T(d)(2) applies to transfers of property denominated in a foreign currency that occur before December 16, 2016, other than transfers occurring before that date resulting from entity classification elections that are filed on or after that date.

T.D. 9800, 12/06/2016; Regulation §1.901(m)-1T, Regulation §1.901(m)-2T, Regulation §1.901(m)-4T, Regulation §1.901(m)-5T, Regulation §1.901(m)-6T.

Temporary regulations under §901(m), that generally follow and expand upon rules contained in a pair of 2014 Notices, and that deny the foreign tax credit with respect to foreign income not subject to U.S. taxation because of covered asset acquisitions.

For contemporaneously issued proposed regulations under §901(m).

Corporate taxpayers that make an election under §338(g) can treat a stock acquisition as an asset acquisition for U.S. tax purposes. One result of a §338 election is that a U.S. acquirer of a foreign company's stock will obtain a fair market value (FMV) basis for the foreign company's assets (assuming that bases of the assets were less than FMV).

A covered asset acquisition (CAA) is:

1. A qualified stock purchase to which §338 applies;
2. Any transaction which is treated as an acquisition of assets for U.S. purposes, and is treated as the acquisition of stock of a corporation (or is disregarded) for purposes of the foreign income taxes of the relevant jurisdiction;
3. Any acquisition of an interest in a partnership which has an election in effect under §754 (§743(b) CAA); and
4. To the extent provided by IRS, any other similar transaction. (§901(m)(2))

CAAs result in a step-up in the basis of the assets of the acquired entity to the FMV that was paid for the stock (or interest in the business entity). In the foreign context, this step-up usually exists only for U.S. tax purposes, and not for foreign tax purposes. As a result, depreciation for U.S. tax purposes exceeds depreciation for foreign tax purposes, so the U.S. taxable base is lower than the foreign taxable base. Because foreign taxes (and therefore foreign tax credit) are based on the foreign taxable base, the foreign tax credit would be overstated, i.e., it would be more than is necessary to avoid double tax on the U.S. tax base.

To reduce the foreign tax credit to the proper amount for CAAs, the "disqualified portion" of any foreign income tax determined with respect to the income or gain attributable to relevant foreign assets (RFAs) is (a) not taken into account in determining the foreign tax credit, and (b) in the case of a foreign income tax paid by a §902 corporation, not taken into account for purposes of the deemed paid credit under §902 or §960. (§901(m)(1)) Instead, the disqualified portion of any foreign income tax is allowed as a deduction. (§901(m)(6))

The disqualified portion is, with respect to any CAA, for any tax year, the ratio of: (a) the aggregate basis differences (but not below zero) allocable to the tax year under §901(m)(3)(B) with respect to all RFAs, divided by (b) the income on which the foreign income tax is determined. If the taxpayer fails to substantiate the income to IRS's satisfaction, the income is determined by dividing the amount of such foreign income tax by the highest marginal tax rate applicable to such income in the relevant jurisdiction. (§901(m)(3)(A))

An RFA is, with respect to any CAA, any asset with respect to the acquisition if income, deduction, gain, or loss attributable to the asset is taken into account in determining the foreign income tax. (§901(m)(4))

Basis difference means, with respect to any RFA, the excess of (i) the adjusted basis of such asset immediately after the CAA, over (ii) the adjusted basis of such asset immediately before the CAA (statutory basis difference). (§901(m)(3)(C)(i)) If the adjusted basis of an RFA immediately before the CAA exceeds the adjusted basis of the RFA immediately after the CAA (that is, where the adjusted basis of an asset with a built-in loss is reduced in a CAA), such excess is a basis difference of a negative amount. (§901(m)(3)(C)(ii))

§901(m)(3)(B)(i) provides the general rule that the basis difference with respect to any RFA will be allocated to tax years using the applicable cost recovery method for U.S. income tax purposes.

§901(m)(3)(B)(ii) (the statutory disposition rule) provides that, except as otherwise provided by IRS, if there is a disposition of any RFA, the basis difference allocated to the tax year of the disposition will be the excess of the basis difference of such asset over the aggregate basis difference of such asset that has been allocated to all prior tax years (unallocated basis difference). No basis difference with respect to such asset will be allocated to any tax year thereafter.

In Notice 2014-44, 2014-32 IRB 270, IRS noted that certain taxpayers are engaging in transactions shortly after a CAA occurs, that are intended to invoke application of the statutory disposition rule to avoid the purpose of §901(m). These taxpayers take the position that the deemed liquidation constitutes a disposition of the RFAs for purposes of §901(m)(3)(B)(ii). They claim that all of the basis difference with respect to the RFAs is allocated to the final tax year of the foreign target that occurs by reason of the deemed liquidation, and that no basis difference with respect to the RFAs is allocated to any later tax year.

Therefore, IRS announced, in Notice 2014-44, that it would issue regulations to close this perceived loophole, which taxpayers are using to avoid disallowance of the foreign tax credit with respect to the disposition of acquired property that has a higher basis for U.S. federal income tax purposes than for foreign tax law purposes. The rules in Notice 2014-44 described the definition of disposition that would be set forth in future regulations, as well as the rules for determining the portion of basis difference that would be taken into account upon a disposition of an RFA (the disposition amount); provided special rules for a §743(b) CAA; and clarified the continuing application of §901(m) to the remaining basis difference.

Notice 2014-44 provided that the future regulations would apply: (i) as to dispositions-to dispositions occurring on or after July 21, 2014; (ii) as to §743(b) CAAs-to §743(b) CAAs occurring on or after July 21, 2014, unless a taxpayer consistently applied those provisions to all §743(b) CAAs occurring on or after January 1, 2011; and (iii) as to successor rules-to remaining basis difference with respect to an RFA as of July 21, 2014, and any basis difference with respect to an RFA that arises in a CAA occurring on or after July 21, 2014.

Notice 2014-45, 2014-34 IRB provided that, in order to prevent abuse, the regulations described in Notice 2014-44 would also apply to determine the tax consequences under §901(m) of an entity classification election made under Regulation §301.7701-3 that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014, including whether a disposition results from the election for purposes of §901(m) and the treatment of any unallocated basis difference that results from such an election.

IRS has now issued temporary and proposed regulations regarding the calculation of the foreign tax credit where there is a CAA. Under the temporary regulations:

a. **Regulation §1.901(m)-2T(c) defines RFA just as §901(m)(4) does, but uses the phrase "subject to a CAA," rather than "with respect to a CAA."** The Preamble provides that an asset is subject to a CAA, if, for example (i) in the case of a qualified stock purchase of a target corporation (as defined in §338(d)(3)) to which §338(a) applies, "new" target is treated as purchasing the asset from "old" target; (ii) in the case of a taxable acquisition of a disregarded entity that is treated as an acquisition of stock for foreign income tax purposes, the asset is owned by the disregard entity at that time of the purchase and therefore the buyer is treated as purchasing the asset from the seller; and (iii) in the case of a §743(b) CAA, the asset is attributable to the partnership interest transferred in the §743(b) CAA. (T.D. 9800)

   Regulation §1.901(m)-2T(d) provides that the statutory definitions under §901(m)(2) and §901(m)(4) apply to determine whether a transaction that occurred during the transition period (as defined under "Effective/applicability dates," below) is a CAA and which assets are RFAs with respect to those CAAs, respectively.

b. **Determining basis difference with respect to an RFA.** A basis difference is computed separately with respect to each foreign income tax for which an asset is an RFA. Consistent with §901(m)(3)(C), Regulation §1.901(m)-4T(b) provides the general rule that basis difference with respect to an RFA is the U.S. basis in the RFA immediately after the CAA, less the U.S. basis in the RFA immediately before the CAA. If, however, an asset is an RFA with respect to a §743(b) CAA, Regulation §1.901(m)-4T(d) provides that basis difference with respect to the RFA is the resulting basis adjustment under §743(b) that is allocated to the RFA under §755 (allocation of basis upon transfer of partnership interest).

c. **Basis difference taken into account**. Regulation §1.901(m)-5T provides rules for determining the amount of basis difference with respect to an RFA that is taken into account in a given U.S. tax year (allocated basis difference). The amount of basis difference taken into account in a U.S. tax year is used to compute a disqualified portion for the U.S. tax year. If an asset is an RFA with respect to more than one foreign income tax, basis difference with respect to each foreign income tax is separately taken into account under Regulation §1.901(m)-5T.

Basis difference is taken into account in two ways: under an applicable cost recovery method or as a result of a disposition of the RFA. Consistent with §901(m)(3)(B)(i), Regulation §1.901(m)-5T(b)(2) provides that a cost recovery amount for an RFA is determined by applying an applicable cost recovery method to the basis difference.

IRS says that the rule of §901(m)(3)(B)(ii) is appropriate when all the gain or loss from the disposition is recognized for both U.S. and foreign income tax purposes. In other cases, however, a disposition may not be the appropriate time for all of the unallocated basis difference to be taken into account. For example, it may not be appropriate for all of the unallocated basis difference to be taken into account upon a disposition that is fully taxable for U.S. income tax purposes but not for foreign income tax purposes. (T.D. 9800)

Regulation §1.901(m)-1T(a)(10) defines a disposition for purposes of §901(m) as an event that results in gain or loss being recognized with respect to an RFA for purposes of U.S. income tax or foreign income tax, or both. Thus, the definition excludes certain transfers that might otherwise be considered dispositions under the ordinary meaning of that term.

Regulation §1.901(m)-5T(c)(2) provides rules for determining a disposition amount. If a disposition of an RFA is fully taxable for U.S. and foreign income tax purposes, the disposition amount will be any remaining unallocated basis difference with respect to that RFA. This is because there generally will no longer be a disparity in the U.S. basis and the foreign basis of the RFA. (Regulation §1.901(m)-5T(c)(2)(i))

If a disposition is not fully taxable for both U.S. and foreign income tax purposes, generally there will continue to be a disparity in the U.S. basis and the foreign basis following the disposition, and it will be appropriate for the RFA to continue to have unallocated basis difference. To the extent that the disparity in the U.S. basis and the foreign basis is reduced as a result of the disposition, however, a portion of the unallocated basis difference (or, in certain cases, all of the unallocated basis difference) is the disposition amount. Whether the disposition reduces the basis disparity will depend on whether the basis difference is positive or negative and the jurisdiction in which gain or loss is recognized. (Regulation §1.901(m)-5T(c)(2)(ii))

The temporary regulations also set out a rule that applies if an asset is an RFA by reason of a §743(b) CAA and subsequently there is a disposition of the RFA. (Regulation §1.901(m)-5T(c)(2)(iii))

d. **Successor rules for unallocated basis difference**. Regulation §1.901(m)-6T(b) provides that §901(m) continues to apply to any unallocated basis difference with respect to an RFA after there is a transfer of the RFA for U.S. income tax purposes (successor transaction), regardless of whether the transfer is a disposition, a CAA, or a non-taxable transaction. A successor transaction does not occur if, as a result of the transfer of an RFA, the entire unallocated basis difference is taken into account because, for example, the transfer results in all realized gain or loss in the RFA being recognized for U.S. and foreign income tax purposes.

The applicability dates of the temporary regulations relate back to the issuance of Notice 2014-44 and Notice 2014-45. Accordingly, the temporary regulations apply to CAAs occurring on or after July 21, 2014, and to CAAs occurring before that date resulting from an entity classification election made under Regulation §301.7701-3 that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014 (the general applicability date). (Regulation §1.901(m)-1T(b)(2), Regulation §1.901(m)-2T(f), Regulation §1.901(m)-4T(g)(1), Regulation §1.901(m)-5T(i)(2), Regulation §1.901(m)-6T(d)(1))

The temporary regulations also apply to CAAs occurring on or after January 1, 2011, and before the general applicability date (the transition period), but only if the statutory basis difference in one or more RFAs with respect to such a CAA had not been fully taken into account under §901(m)(3)(B) either: a) as of July 21, 2014, or b) in the case of an entity classification election made under Regulation §301.7701-3 that is filed on or after July 29, 2014, and that is effective on or before July 21, 2014-prior to the transactions that are deemed to occur under Regulation §301.7701-3(g) as a result of the change in classification. (Regulation §1.901(m)-1T(b)(2))

Taxpayers also may choose to consistently apply Regulation §1.901(m)-4T(d)(1) (regarding the determination of basis difference in an RFA with respect to a §743(b) CAA) to all §743(b) CAAs occurring on or after January 1, 2011. (Regulation §1.901(m)-4T(g)(1))

T.D. 9796, 12/12/2016; Regulation §1.6038A-1, Regulation §1.6038A-2, Regulation §301.7701-2.

Final regulations that treat a domestic disregarded entity wholly owned by a foreign person as a domestic corporation separate from its owner, but only for the reporting, record maintenance, and associated compliance requirements that apply to 25% foreign-owned domestic corporations under §6038A. These changes are intended to provide IRS with improved access to information that it needs to satisfy its obligations under U.S. tax treaties, tax information exchange agreements and similar international agreements, as well as to strengthen the enforcement of U.S. tax laws.

Regulation §301.7701-1 through Regulation §301.7701-3 (the entity classification regulations) classify a business entity with two or more members as either a corporation or a partnership, and a business entity with a single owner as either a corporation or an entity disregarded as separate from its owner (disregarded entity). Certain domestic business entities, such as limited liability companies (LLCs), are classified by default as partnerships (if they have more than one member) or as disregarded entities (if they have only one owner) but are eligible to elect for federal tax purposes to be classified as corporations.

When an entity, such as an LLC, is classified as a corporation or a partnership for tax purposes, general ownership and accounting information is available to IRS through the return filing and EIN application requirements. However, a disregarded entity is not subject to a separate income or information return filing requirement. Its owner is treated as owning directly the entity's assets and liabilities, and the information available with respect to the disregarded entity depends on the owner's own return filings, if any are required.

For a disregarded entity that is formed in the U.S. and wholly owned by a foreign corporation, foreign partnership, or nonresident alien individual, generally no U.S. income or information return must be filed if neither the disregarded entity nor its owner received any U.S. source income or was engaged in a U.S. trade or business during the tax year. Moreover, if a disregarded entity only receives certain types of U.S. source income, such as portfolio interest or U.S. source income that is fully withheld upon at source, its owner may not have a U.S. return filing requirement. Even in cases when the disregarded entity has an EIN, as well as in cases when income earned through a disregarded entity must be reported on its owner's return (for example, income from a U.S. trade or business), it may be difficult to associate the income with the disregarded entity based solely on the owner's return.

In general, §6038A imposes reporting and recordkeeping requirements (together with certain procedural compliance requirements) on domestic corporations that are at least 25% foreign-owned. They are required to file an annual return on Form 5472 (Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business) with respect to each related party with which the reporting corporation has had any reportable transactions. (Regulation §1.6038A-2) These corporations must keep the permanent books of account or records as required by §6001 that are sufficient to establish the accuracy of the federal income tax return of the corporation, including information, documents, or records to the extent they may be relevant to determine the correct U.S. tax treatment of transactions with related parties. (Regulation §1.6038A-3)

In May, 2016, IRS issued proposed regulations that would amend Regulation §301.7701-2(c) to treat a domestic disregarded entity that is wholly owned by one foreign person as a domestic corporation separate from its owner for the limited purposes of the reporting and record maintenance requirements (including the associated procedural compliance requirements) under §6038A. (Proposed Regulation §301.7701-2(c)(2)(vi)) The proposed regulations did not alter the framework of the existing entity classification regulations, including the treatment of certain entities as disregarded entities. (Preamble to Proposed Regulation 05/06/2016)

The final regulations keep the provisions from the proposed regulations, add some new ones, and change the effective date of the regulations.

Because the final regulations treat the affected domestic entities as foreign-owned domestic corporations for §6038A, they are reporting corporations under §6038A. (Regulation §1.6038A-1(c)(1)) Accordingly, they are required to file Form 5472 with respect to reportable transactions between the entity and its foreign owner or other foreign related parties (transactions that would have been regarded under general U.S. tax principles if the entity had been, in fact, a corporation for U.S. tax purposes). They also are required to maintain records sufficient to establish the accuracy of the information return and the correct U.S. tax treatment of such transactions. In addition, because these entities would have a filing obligation, they would be required to obtain an EIN by filing a Form SS-4 (Application for Employer Identification Number) that includes responsible party information. (Preamble to Proposed Regulation 05/06/2016)

As under the proposed regulations, to ensure that such entities are required to report all transactions with foreign related parties, the final regulations specify as an additional reportable category of transaction any transaction under Regulation §1.482-1(i)(7) (with such entities being treated as separate taxpayers for the purpose of identifying transactions and being subject to requirements under §6038A) to the extent not already covered by another reportable category. (Regulation §1.6038A-2(b)(3)(x)) The term "transaction" is defined in Regulation §1.482-1(i)(7) to include any sale, assignment, lease, license, loan, advance, contribution, or other transfer of any interest in or a right to use any property or money, as well as the performance of any services for the benefit of, or on behalf of, another taxpayer.

And, as under the proposed regulations, the exceptions to the record maintenance requirements for small corporations in Regulation §1.6038A-1(h) (i.e., for reporting corporations that have less than $10 million in U.S. gross receipts for a tax year) and for de minimis transactions in Regulation §1.6038A-1(h) (i.e., for any tax year in which the aggregate value of gross payments that the reporting corporation makes to and receives from foreign related parties with respect to related party transactions is not more than $5 million and is less than 10% of its U.S. gross income) do not apply to these entities. (Regulation §1.6038A-1(h), Regulation §1.6038A-1(i))

The final regulations make the final additions to the proposed regulations:

a. The proposed regulations did not address the exception provided in Regulation §1.6038A-2(e)(3), under which a reporting corporation is not required to file Form 5472 with respect to a related foreign corporation when a U.S. person that controls the related foreign corporation files a Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, containing required information with respect to reportable transactions between the reporting corporation and the related foreign corporation for the tax year. Similarly, the proposed regulations did not address the exception provided in Regulation §1.6038A-2(e)(4), under which a reporting corporation is not required to file Form 5472 with respect to a related foreign corporation that qualifies as a foreign sales corporation for a tax year for which the foreign sales corporation files Form 1120-FSC, U.S. Income Tax Return of a Foreign Sales Corporation.

The final regulations provide that, for the entities covered by the regulations, the exceptions under Regulation §1.6038A-2(e)(3) and Regulation §1.6038A-2(e)(4) do not apply. (Regulation §1.6038A-2(e)(3), Regulation §1.6038A-2(e)(4))

b. To facilitate entities' compliance with the requirements of §6038A, including the obligation of reporting corporations to file Form 5472, the final regulations provide that these entities have the same tax year as their foreign owner if the foreign owner has a U.S. return filing obligation. If the foreign owner has no U.S. return filing obligation, the final regulations provide that the tax year of these entities is the calendar year unless otherwise provided in forms, instructions, or published guidance. (Regulation §301.7701-2(c)(2)(vi)(C))

The proposed regulations had provided that the regulations would be applicable for tax years ending on or after the date that is 12 months after the date the regulations were published as final regulations. (Proposed Regulation §1.6038A-1(n), Proposed Regulation §301.7701-2(e)(9)) However, the final regulations provide that they apply to tax years of entities beginning on or after January 1, 2017, and ending on or after December 13, 2017. (Regulation §1.6038A-1(n), Regulation §301.7701-2(e)(9))

Preamble to Proposed Regulation 12/06/2016; Proposed Regulation §1.901(m)-1, Proposed Regulation §1.901(m)-2, Proposed Regulation §1.901(m)-3, Proposed Regulation §1.901(m)-4, Proposed Regulation §1.901(m)-5, Proposed Regulation §1.901(m)-6, Proposed Regulation §1.901(m)-7, Proposed Regulation §1.901(m)-8.

Proposed regulations that would provide rules for computing the disqualified portion of foreign income taxes under §901(m) that is not taken into account for purposes of calculating the foreign income tax credit. The regulations would cover transactions that generally are treated as asset acquisitions for U.S. income tax purposes but that are either treated as stock acquisitions or disregarded for foreign income tax purposes.

IRS also contemporaneously issued temporary regulations under §901(m), the text of which serves as the text of a portion of the proposed regulations.

Statutory background. Corporate taxpayers that make an election under §338(g) can treat a stock acquisition as an asset acquisition for U.S. tax purposes. One result of a §338 election is that a U.S. acquirer of a foreign company's stock will obtain a fair market value (FMV) basis for the foreign target's assets (assuming that bases of the assets were less than FMV). The same step-up in basis can be achieved by acquiring the stock of a foreign corporation that is treated as a corporation for foreign tax purposes and as a pass-through for U.S. tax purposes.

A covered asset acquisition (CAA) is:

1. A qualified stock purchase to which §338 applies;

2. Any transaction which is treated as an acquisition of assets for U.S. purposes, and is treated as the acquisition of stock of a corporation (or is disregarded) for purposes of the foreign income taxes of the relevant jurisdiction;

3. Any acquisition of an interest in a partnership which has an election in effect under §754 (§743(b) CAA); and

4. To the extent provided by IRS, any other similar transaction. (§901(m)(2))

CAAs result in a step-up in the basis of the assets of the acquired entity to the FMV that was paid for the stock (or interest in the business entity). In the foreign context, this step-up usually exists only for U.S. tax purposes, and not for foreign tax purposes. As a result, depreciation for U.S. tax purposes exceeds depreciation for foreign tax purposes, so the U.S. taxable base is lower than foreign taxable base. Because foreign taxes (and therefore foreign tax credit) are based on the foreign taxable base, the foreign tax credit would be overstated, i.e., it would be more than is necessary to avoid double tax on the U.S. tax base.

To reduce the foreign tax credit to the proper amount in situations like that described above, i.e., for CAAs, the "disqualified portion" of any foreign income tax determined with respect to the income or gain attributable to relevant foreign assets (RFAs) is (a) not taken into account in determining the foreign tax credit, and (b) in the case of a foreign income tax paid by a §902 corporation, not taken into account for purposes of the deemed paid credit under §902 or §960. (§901(m)(1)) Instead, the disqualified portion of any foreign income tax is allowed as a deduction. (§901(m)(6))

The disqualified portion is, with respect to any CAA, for any tax year, the ratio of: (a) the aggregate basis differences (but not below zero) allocable to the tax year under §901(m)(3)(B) with respect to all RFAs, divided by (b) the income on which the foreign income tax is determined. If the taxpayer fails to substantiate the income to IRS's satisfaction, the income is determined by dividing the amount of such foreign income tax by the highest marginal tax rate applicable to such income in the relevant jurisdiction. (§901(m)(3)(A))

An RFA is, with respect to any CAA, any asset (including any goodwill, going concern value, or other intangible) with respect to the acquisition if income, deduction, gain, or loss attributable to the asset is taken into account in determining the foreign income tax. (§901(m)(4))

Basis difference means, with respect to any RFA, the excess of (i) the adjusted basis of such asset immediately after the CAA, over (ii) the adjusted basis of such asset immediately before the CAA. (§901(m)(3)(C)(i)) If the adjusted basis of an RFA immediately before the CAA exceeds the adjusted basis of the RFA immediately after the CAA (that is, where the adjusted basis of an asset with a built-in loss is reduced in a CAA), such excess is taken into account as a basis difference of a negative amount. (§901(m)(3)(C)(ii)) Under §901(m)(3)(B)(i), the basis difference with respect to any RFA will generally be allocated to tax years using the applicable cost recovery method for U.S. income tax purposes.

§901(m)(3)(B)(ii) (the statutory disposition rule) provides that, except as otherwise provided by IRS, if there is a disposition of any RFA, the basis difference allocated to the tax year of the disposition will be the excess of the basis difference of such asset over the aggregate basis difference of such asset that has been allocated to all prior tax years ("Unallocated Basis Difference"). No basis difference with respect to such asset will be allocated to any tax year thereafter.

In 2014, IRS issued Notice 2014-44, 2014-32 IRB 270 and Notice 2014-45, 2014-34 IRB 388, announcing its intent to issue regulations addressing the application of §901(m) to dispositions of RFAs following CAAs and to CAAs described in §901(m)(2)(C) and providing successor rules for the continued application of §901(m) after subsequent transfers of RFAs with remaining basis difference. The temporary regulations provide the rules described in these Notices.

IRS has now issued temporary and proposed §901(m) regulations. Here are highlights of the proposed regulations:

Proposed Regulation §1.901(m)-1 provides definitions that would apply for purposes of the proposed regulations, including:

a. A "section 901(m) payor" is a person eligible to claim the foreign tax credit allowed under §901(a), or a §902 corporation, that is required to compute a disqualified portion when §901(m) applies.

b. A "foreign payor" is the individual or entity (including a disregarded entity) subject to a foreign income tax.

c. An "RFA owner (U.S.)" is the person that owns one or more RFAs for U.S. income tax purposes and therefore is required to report, or otherwise track, items of income, deduction, gain, or loss attributable to the RFAs for purposes of computing its U.S. taxable income.

d. An "RFA owner (foreign)" is the individual or entity (including a disregarded entity) that owns one or more RFAs for purposes of a foreign income tax and that therefore generally would report, or otherwise track, items of income, deduction, gain, or loss attributable to the RFAs for purposes of determining income reported on a foreign income tax return.

An entity can be classified as more than one of the above. (Preamble to Proposed Reg)

Proposed Regulation §1.901(m)-2 identifies six transactions that would be CAAs-three of which are provided by statute, and three of which are identified as such pursuant to IRS's authority under §901(m)(2)(D).

The three newly identified CAAs described in the proposed regulations would be any transactions (or series of transactions occurring pursuant to the plan) to the extent it they are treated as:

1. Acquisitions of assets for purposes of U.S. income tax and as acquisitions of an interest in a fiscally transparent entity for purposes of a foreign income tax; (Proposed Regulation §1.901(m)-2(b)(4))

2. Partnership distributions of one or more assets the U.S. basis of which is determined by §732(b) or §732(d) or which causes the U.S. basis of the partnership's remaining assets to be adjusted under §734(b), provided the transactions result in an increase in the U.S. basis of one or more of the assets distributed by the partnership or retained by the partnership without a corresponding increase in the foreign basis of such assets; (Proposed Regulation §1.901(m)-2(b)(5)) and

3. Acquisitions of assets for purposes of both U.S. income tax and a foreign income tax, provided the transactions result in an increase in the U.S. basis without a corresponding increase in the foreign basis of one or more assets. (Proposed Regulation §1.901(m)-2(b)(6))

Proposed Regulation §1.901(m)-3 provides rules that would apply for computing the disqualified portion of foreign income taxes and the treatment under §901(m)(1) of the disqualified portion. The disqualified portion would be the lesser of the tentative disqualified tax amount and the foreign income tax amount paid or accrued by, or considered paid or accrued by, a section 901(m) payor. The tentative disqualified tax amount would generally be determined using a modified version of the formula provided in §901(m)(3), above. (Proposed Regulation §1.901(m)-3(b)(2))

The proposed regulations would also provide rules for determining whether and to what extent basis difference that is assigned to a given tax year would be carried over to subsequent tax years. (Proposed Regulation §1.901(m)-3(c))

Proposed Regulation §1.901(m)-4 provides rules that would apply for determining the basis difference with respect to an RFA, including an election to use foreign basis for purposes of this determination.

Proposed Regulation §1.901(m)-4 would incorporate by cross reference the general rules in the temporary regulations for determining basis difference, under which basis difference is determined separately with respect to each foreign income tax for which an asset is an RFA.

Proposed Regulation §1.901(m)-4(c) provides for a foreign basis election, pursuant to which basis difference would equal the U.S. basis in the RFA immediately after the CAA, less the foreign basis in the RFA immediately after the CAA. With limited exceptions, a foreign basis election would be made by the RFA owner (U.S.), on a timely filed original federal income tax return for the first U.S. tax year that the foreign basis election is relevant, by using foreign basis to determine the basis differences for purposes of computing a disqualified tax amount and an aggregate basis difference carryover.

Proposed Regulation §1.901(m)-5 provides rules that would apply for taking into account basis difference under an applicable cost recovery method or as a result of a disposition of an RFA, rules for allocating that basis difference, when necessary, to one or more persons subject to §901(m), and rules for assigning that basis difference to a U.S. tax year. Proposed Regulation §1.901(m)-5(b)(2)(i) would incorporate by cross reference the general rule in the temporary regulations that a cost recovery amount for an RFA is determined by applying an "applicable cost recovery method" (e.g., depreciation) to the basis difference rather than to the U.S. basis of the RFA. If the entire U.S. basis of the RFA is not subject to the same cost recovery method, the applicable cost recovery method for determining the cost recovery amount would be the cost recovery method that applies to the portion of the U.S. basis that corresponds to the basis difference. (Proposed Regulation §1.901(m)-5(b)(2)(ii))

When an RFA owner (U.S.) is a section 901(m) payor, all of the cost recovery amount would be attributed to the section 901(m) payor and assigned to the U.S. tax year of the section 901(m) payor in which the corresponding U.S. basis deduction with respect to the RFA is taken into account under the applicable cost recovery method. (Proposed Regulation §1.901(m)-5(b)(1)) If, instead, the RFA owner (U.S.) is not a section 901(m) payor but a fiscally transparent entity for U.S. income tax purposes in which a section 901(m) payor directly or indirectly owns an interest, Proposed Regulation §1.901(m)-5(d)(2) would allocate all or a portion of the cost recovery amount to the section 901(m) payor. Special rules would apply to certain " §743(b) CAAs," as well as in certain cases involving a reverse hybrid entity (i.e., one that is treated as a corporation for U.S. income tax purposes but as a fiscally transparent entity for foreign income tax purposes).

The proposed regulations would incorporate by reference the rules provided in the temporary regulations for determining the amount of basis difference taken into account upon the disposition of an RFA (the "disposition amount"), and would provide rules to determine how to attribute or allocate a disposition amount to a section 901(m) payor. In general, when the RFA owner (U.S.) is a section 901(m) payor, all of the disposition amount would be attributed to the section 901(m) payor and assigned to the U.S. tax year of the section 901(m) payor in which the disposition occurs. (Proposed Regulation §1.901(m)-5(c)(1)) However, if, instead, the RFA owner (U.S.) is not a section 901(m) payor but a fiscally transparent entity for U.S. income tax purposes in which a section 901(m) payor directly or indirectly owns an interest, Proposed Regulation §1.901(m)-5(d) provides detailed rules that, with limited exceptions (including for certain section 743(b) CAAs, mid-year transactions, and reverse hybrids), would generally allocate all or a portion of a disposition amount to the section 901(m) payor and assign it to a U.S. tax year of the section 901(m) payor. These rules would vary depending on, among other things, whether the disposition amount is attributable to a foreign disposition gain or loss or U.S. disposition gain or loss.

Proposed Regulation §1.901(m)-6 would provide successor rules for applying §901(m) to subsequent transfers of RFAs that have a basis difference that has not yet been fully taken into account ("unallocated basis difference"), as well as for transferring an aggregate basis difference carryover of a person subject to §901(m) either to another aggregate basis difference carryover account of such person or to another person subject to §901(m).

In general, §901(m) would continue to apply to an RFA after it has been transferred for U.S. income tax purposes if the RFA continues to have an unallocated basis difference following the transfer (a successor transaction). (Proposed Regulation §1.901(m)-6(b)(1))

An aggregate basis difference carryover would be treated as a tax attribute of the section 901(m) payor that retains its character as an aggregate basis difference carryover with respect to a foreign income tax and a foreign payor and with respect to a separate category, as described in Regulation §1.904-4(m). When a section 901(m) payor transfers its assets in a transaction to which §381 applies, Proposed Regulation §1.901(m)-6(c)(1) would provide that any aggregate basis difference carryovers of the section 901(m) payor are transferred to the corporation that succeeds to the earnings and profits, if any. When substantially all of the assets of one foreign payor are transferred to another foreign payor, both of which are directly or indirectly owned by the same section 901(m) payor, Proposed Regulation §1.901(m)-6(c)(1) would provide that an aggregate basis difference carryover of the section 901(m) payor with respect to the transferor foreign payor becomes an aggregate basis difference carryover of the section 901(m) payor with respect to the transferee foreign payor.

Proposed Regulation §1.901(m)-6(c)(3) would provide an anti-abuse rule that would transfer an aggregate basis difference carryover when, with a principal purpose of avoiding the application of §901(m), there is a transfer of assets or a change in either the allocation of foreign income for foreign income tax purposes or the allocation of foreign income tax amounts for U.S. income tax purposes, that is intended to separate foreign income tax amounts from the related aggregate basis difference carryover.

Proposed Regulation §1.901(m)-7 would provide de minimis rules under which a basis difference with respect to an RFA generally would not be taken into account for purposes of §901(m) if either (i) the sum of the basis differences for all RFAs with respect to the CAA is less than the greater of $10 million or 10% of the total U.S. basis of all RFAs immediately after the CAA; or (ii) the RFA is part of a class of RFAs (i.e., one of the seven asset classes in Regulation §1.338-6(b)) for which the sum of the basis differences of all RFAs in the class is less than the greater of $2 million or 10% of the total U.S. basis of all RFAs in the class. For transactions between related parties, the threshold dollar amounts and percentages to meet the de minimis exemptions for related party CAAs would equal half the amount set for unrelated party CAAs, and the de minimis exemptions would not apply to CAAs between related parties that are entered into or structured with a principal purpose of avoiding the application of §901(m). (Proposed Regulation §1.901(m)-7(b))

Proposed Regulation §1.901(m)-8(b) would generally provide that, when a foreign corporation becomes a §902 corporation for the first time, as part of the required reconstruction of the U.S. tax history of the pre-1987 foreign income taxes of the foreign corporation, §901(m) and the proposed regulations would apply to determine any disqualified tax amounts or aggregate basis difference carryovers that apply to the foreign corporation.

And, under Proposed Regulation §1.901(m)-8(c), an anti-abuse rule would apply to disregard an RFA with a built-in loss to the extent it relates to any asset acquisition structured with a principal purpose to use that RFA to avoid the application of §901(m).

The proposed regulations would also make a number of modifications to the §704(b) regulations related to §901(m). (Preamble to Proposed Reg)

The proposed regulations would generally apply to CAAs occurring on or after the date that they are adopted as final regulations. Taxpayers may, however, rely on the proposed regulations prior to that date provided that they both consistently apply Proposed Regulation §1.901(m)-2 (excluding Proposed Regulation §1.901(m)-2(d)) to all CAAs occurring on or after December 7, 2016, and consistently apply Proposed Regulation §1.901(m)-1 and Proposed Regulation §1.901(m)-3 through Proposed Regulation §1.901(m)-8 (excluding Proposed Regulation §1.901(m)-4(e)) to all CAAs occurring on or after January 1, 2011. For this purpose, persons that are related (within the meaning of §267(b) or §707(b)) will be treated as a single taxpayer.

Preamble to Proposed Regulation 11/22/2016; Proposed Regulation §1.514(c)-2.

Proposed regulations that would liberalize and simplify the "fractions rule," a rule which provides an exception to the rule that a portion of gross income derived from debt-financed real property is unrelated business taxable income, and which applies where that income is earned by certain partnerships in which a tax-exempt organization is a partner.

§511 imposes a tax on the unrelated business taxable income (UBTI) of tax-exempt organizations. §514(a) defines UBTI to include a specified percentage of the gross income derived from debt-financed property described in §514(b). §514(c)(9)(A) generally excepts from UBTI income derived from debt-financed real property acquired or improved by certain qualified organizations (QOs) described in §514(c)(9)(C). Under §514(c)(9)(C), a QO includes an educational organization described in §170(b)(1)(A)(ii) and its affiliated support organizations described in §509(a)(3), any trust which constitutes a qualified trust under §401, an organization described in §501(c)(25), and a retirement income account described in §403(b)(9).

§514(c)(9)(B)(vi) provides that the exception from UBTI in §514(c)(9)(A) does not apply to a situation in which the QO owns an interest in a partnership that holds debt financed real property (the partnership limitation), unless the partnership meets one of several requirements. One of those requirements is that each partnership allocation has substantial economic effect under §704(b)(2) and satisfies §514(c)(9)(E)(i)(I) (the fractions rule). (§514(c)(9)(B)(vi)) The function of these requirements is to prevent exempt partners from trading tax deductions that they are unable to get a tax benefit from, to taxable partners. (Regulation §1.514(c)-2(k)(4))

A partnership allocation satisfies the fractions rule if the allocation of items to any partner that is a QO does not result in that partner having a share of overall partnership income for any tax year greater than that partner's fractions rule percentage (the partner's share of overall partnership loss for the tax year for which the partner's loss share is the smallest). (§514(c)(9)(E)(i)(I)) Overall partnership income as the amount by which the aggregate items of partnership income and gain for the tax year exceed the aggregate items of partnership loss and deduction for the year. Overall partnership loss is the amount by which the aggregate items of partnership loss and deduction for the tax year exceed the aggregate items of partnership income and gain for the year. (Regulation §1.514(c)-2(c)(1))

Generally, under Regulation §1.514(c)-2(b)(2)(i), a partnership must satisfy the fractions rule both on a prospective basis and on an actual basis for each tax year of the partnership, beginning with the first tax year of the partnership in which the partnership holds debt-financed real property and has a QO partner.

However, certain allocations are taken into account for purposes of determining overall partnership income or loss only when actually made, and do not create an immediate violation of the fractions rule. (Regulation §1.514(c)-2(b)(2)(i)) Certain other allocations are disregarded for purposes of making fractions rule calculations. See, for example, Regulation §1.514(c)-2(d) (reasonable preferred returns and reasonable guaranteed payments), Regulation §1.514(c)-2(e) (certain chargebacks and offsets), Regulation §1.514(c)-2(f) (reasonable partner-specific items of deduction and loss), Regulation §1.514(c)-2(g) (unlikely losses and deductions), and Regulation §1.514(c)-2(k)(3) (certain de minimis allocations of losses and deductions). In addition, Regulation §1.514(c)-2(k)(1) provides that changes in partnership allocations that result from transfers or shifts of partnership interests (other than transfers from a QO to another QO) will be closely scrutinized, but generally will be taken into account only in determining whether the partnership satisfies the fractions rule in the tax year of the change and subsequent tax years.

The proposed regulations would make several changes, including the following:

a. **Preferred returns.** Regulation §1.514(c)-2(d)(1) and Regulation §1.514(c)-2(d)(2) of the existing regulations disregard, in computing overall partnership income for purposes of the fractions rule, items of income (including gross income) and gain that may be allocated to a partner with respect to a current or cumulative reasonable preferred return for capital (including allocations of minimum gain attributable to nonrecourse liability proceeds distributed to the partner as a reasonable preferred return) if that preferred return is set forth in a binding, written partnership agreement. Regulation §1.514(c)-2(d)(2) provides that if a partnership agreement provides for a reasonable preferred return with an allocation of what would otherwise be overall partnership income, items comprising that allocation are disregarded in computing overall partnership income for purposes of the fractions rule.

   Regulation §1.514(c)-2(d)(6)(i) limits the amount of income and gain allocated with respect to a preferred return that can be disregarded for purposes of the fractions rule to: (A) the aggregate of the amount that has been distributed to the partner as a reasonable preferred return for the tax year of the allocation and prior tax years, on or before the due date (not including extensions) for filing the partnership's return for the tax year of the allocation; minus (B) the aggregate amount of corresponding income and gain allocated to the partner in all prior years. Thus, this rule requires a current distribution of preferred returns for the allocations of income with respect to those preferred returns to be disregarded.

   Responding to comments that this current distribution requirement interferes with normal market practice, creates unnecessary complication, and, in some cases, causes economic distortions for partnerships with QO partners, the proposed regulations would remove the current distribution requirement and would instead disregard allocations of items of income and gain with respect to a preferred return for purposes of the fractions rule. But this rule would only apply if the partnership agreement required that the partnership make distributions first to pay any accrued, cumulative, and compounding unpaid preferred return to the extent such accrued but unpaid preferred return had not otherwise been reversed by an allocation of loss prior to such distribution (preferred return distribution requirement). The preferred return distribution requirement, however, would be subject to an exception that would allow distributions intended to facilitate partner payment of taxes imposed on the partner's allocable share of partnership income or gain, if the distributions were made pursuant to a provision in the partnership agreement, were treated as an advance against distributions to which the distributee partner would otherwise be entitled under the partnership agreement, and do not exceed the distributee partner's allocable share of net partnership income and gain multiplied by the sum of the highest statutory federal, state, and local tax rates applicable to that partner. (Proposed Regulation §1.514(c)-2(d)(2))

b. **Partner-specific expenditures and management fees**. Regulation §1.514(c)-2(f) provides a list of certain partner-specific expenditures that are disregarded in computing overall partnership income or loss for purposes of the fractions rule.

IRS is aware that some real estate partnerships allow investing partners to negotiate for management and similar fees paid to the general partner that differ from fees paid with respect to investments by other partners. These fees include the general partner's fees for managing the partnership and may include fees paid in connection with the acquisition, disposition, or refinancing of an investment.

IRS has determined that real estate partnerships with QO partners should be permitted to allocate management and similar fees among partners to reflect the manner in which the partners agreed to bear the expense, without causing a fractions rule violation. Accordingly, the proposed regulations would add management (and similar) fees to the current list of excluded partner-specific expenditures in Regulation §1.514(c)-2(f) to the extent such fees do not, in the aggregate, exceed 2% of the partner's aggregate committed capital. (Proposed Regulation §1.514(c)-2(f)(4))

IRS is also seeking comments on applying the partner-specific expenditure rules for purposes of the new partnership audit rules in §1101 of the Bipartisan Budget Act of 2015, PL 114-74.

c. **Capital commitment defaults or reductions**. In the typical real estate partnership, a limited partner generally will not contribute its entire investment upon being admitted as a partner. Rather, that limited partner will commit to contribute a certain dollar amount over a fixed period of time, and the general partner will then "call" on that committed, but uncontributed, capital as needed.

Partnership agreements often contain remedies that apply if a partner fails to contribute a portion (or all) of its committed capital. For example: (i) allowing the non-defaulting partner(s) to contribute additional capital in return for a preferred return on that additional capital; or (ii) causing the defaulting partner to forfeit all or a portion of its interest in the partnership. Depending on the facts, these types of partnership agreement provisions could raise fractions rule concerns.

IRS has determined that changes in allocations resulting from unanticipated defaults or reductions do not violate the purpose of the fractions rule if such changes are provided for in the partnership agreement. Therefore, the proposed regulations provide that, if the partnership agreement provides for changes to allocations due to an unanticipated partner default on a capital contribution commitment or an unanticipated reduction in a partner's capital contribution commitment, and those changes in allocations are not inconsistent with the purpose of the fractions rule under Regulation §1.514(c)-2(k)(4), then: (A) changes to partnership allocations provided in the agreement would not be closely scrutinized under Regulation §1.514(c)-2(k)(1) and (B) partnership allocations of income, loss, or deduction (including allocations to adjust partners' capital accounts to be consistent with the partners' adjusted capital commitments) to partners to adjust the partners' capital accounts as a result of unanticipated capital contribution defaults or reductions would be disregarded in computing overall partnership income or loss for purposes of the fractions rule. (Proposed Regulation §1.514(c)-2(k)(1)(iii))

d. **De minimis exceptions.** Regulation §1.514(c)-2(k)(2) provides that the partnership limitation in §514(c)(9)(B)(vi) does not apply to a partnership if all QOs hold no more than 5% in the capital or profits of the partnership, and taxable partners own substantial interests in the partnership through which they participate in the partnership on substantially the same terms as the QO partners. If the partnership limitation in §514(c)(9)(B)(vi) does not apply to the partnership, the fractions rule does not apply to the partnership.

IRS has determined that the purpose of the fractions rule is not violated if all non-QO partners hold a de minimis interest. Therefore, the proposed regulations provide that the fractions rule would not apply to a partnership in which non-QO partners do not hold (directly or indirectly through a partnership), in the aggregate, interests of greater than 5% in the capital or profits of the partnership, so long as the partnership's allocations had substantial economic effect. For purposes of the proposed rule, the determination of whether an allocation has substantial economic effect would be made without application of the special rules in Regulation §1.704-1(b)(2)(iii)(c)(2) (which contain certain presumptions). (Proposed Regulation §1.514(c)-2(k)(2)(ii))

The existing regulations also provide for a de minimis exception for allocations away from QO partners. Regulation §1.514(c)-2(k)(3) provides that a QO's fractions rule percentage of the partnership's items of loss and deduction, other than nonrecourse and partner nonrecourse deductions, that are allocated away from the QO and to other partners in any tax year, are treated as having been allocated to the QO for purposes of the fractions rule if: (i) the allocation was neither planned nor motivated by tax avoidance; and (ii) the total amount of those items of partnership loss or deduction is less than both 1% of the partnership's aggregate items of gross loss and deduction for the tax year and $50,000. The preamble to the existing final regulations under §514(c)(9)(E) explained that the de minimis allocation exception was "to provide relief for what would otherwise be minor inadvertent violations of the fractions rule."

The proposed regulations would increase the above $50,000 amount to $1,000,000. (Proposed Regulation §1.514(c)-2(k)(3))

e. The proposed regulations also contain changes to rules on the following subjects.

1. **Chargebacks of partner-specific expenditures and unlikely losses**. Similar to Regulation §1.514(c)-2(f), Regulation §1.514(c)-2(g) generally disregards specially allocated unlikely losses or deductions in computing overall partnership income or loss for purposes of the fractions rule. Because allocations of partner-specific expenditures in Regulation §1.514(c)-2(f) and unlikely losses in Regulation §1.514(c)-2(g) are disregarded in computing overall partnership income or loss, allocations of items of income or gain or net income to reverse the prior partner-specific expenditure or unlikely loss could cause a violation of the fractions rule. The proposed regulations would make changes to the existing rule-the chargeback rule-that generally disregards those reversals for purposes of the fractions rule. (Proposed Regulation §1.514(c)-2(e)(1))

2. **Acquisition of partnership interests after initial formation of partnership.** The proposed regulations would make changes to existing regulation special rules regarding changes in partnership allocations arising from a change in partners' interests. (Proposed Regulation §1.514(c)-2(k)(1)(ii))

3. **How to apply the fractions rule to tiered partnerships**. (Proposed Regulation §1.514(c)-2(m)(2), Ex. 3)

The regulations are proposed to apply to tax years ending on or after the date they are published as final regulations in the Federal Register. (Proposed Regulation §1.514(c)-2(n)(2)) However, a partnership and its partners may apply all the rules in the proposed regulations for tax years ending on or after November 23, 2016. (Preamble to Proposed Regulation 11/22/2016)

T.D. 9792, 11/02/2016; Regulation §1.954-2, Regulation §1.956-1, Regulation §1.956-1T, Regulation §1.956-2, Regulation §1.956-3, Regulation §1.956-4.

Final regulations covering: a) several aspects of what constitutes U.S. property for purposes of the rule under which a U.S. shareholder of a controlled foreign corporation (CFC) includes in income an amount based on the CFC's investments in U.S. property; and b) when a CFC is considered to derive rents and royalties in the active conduct of a trade or business for purposes of determining foreign base company income (FBCI).

For contemporaneously issued proposed regulations on treatment, for purposes of the CFC U.S. property rules, of property owned by a partnership that is controlled by a partner.

In general, U.S. shareholders of a foreign corporation are not subject to U.S. taxation on the income of the foreign corporation until an actual dividend is remitted by the foreign corporation to the U.S. shareholders. However, different rules apply to U.S. shareholders of a CFC.

A CFC is defined in §957(a) as any foreign corporation if more than 50% of the total combined voting power of all classes of stock entitled to vote, or more than 50% of the total value of the stock of the corporation, is owned directly, indirectly, or constructively by U.S. shareholders on any day during the tax year of the foreign corporation. A U.S. shareholder, in turn, is any U.S. person who owns, directly, indirectly, or constructively 10% of more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation. (§951(b)

The U.S. shareholders of a CFC must generally include in gross income, among other things, their pro rata share of the CFC's subpart F income and the increase during the tax year in earnings of the CFC invested in U.S. property (to the extent not included as Subpart F income). (§951)

a. **Subpart F income.** Subpart F income generally consists of certain types of passive income, one category of which is FBCI. FBCI is defined by §954 as income earned by a CFC that is taken into account in computing the amount that a U.S. shareholder of the CFC must include in income under §951(a)(1)(A). FBCI includes foreign personal holding company income (FPHCI), as defined in §954(c), which, in turn, generally includes rents and royalties. (§954(c)(1)(A)) However, rents and royalties are excluded from FPHCI under the "active rents and royalties exception" if they are received from a person other than a related person and derived in the active conduct of a trade or business within the meaning of §954(c)(2)(A) and Regulation §1.954-2.

b. **Investments in U.S. property.** A U.S. shareholder of a CFC includes in income a pro rata amount based on the CFC's investments in U.S. property, whether held directly or indirectly. (§956) "U.S. property" includes, among other things, tangible property located in the U.S., stock of a domestic corporation, and certain obligations of U.S. persons. (§956(c)) An indirect investment would include, for example, property held on a CFC's behalf by a trust or nominee.

IRS has express authority under §956(e) to issue regulations necessary to carry out the purposes of §956, including to prevent the avoidance of that section (i.e., to avoid current income inclusion for U.S. shareholders). To this end, under Regulation §1.956-1T(b)(4) (the "anti-avoidance rule"), at the District Director's discretion, a CFC will be considered to indirectly hold investments in U.S. property acquired by any other foreign corporation that is controlled by the CFC if one of the principal purposes for creating, organizing, or funding (through capital contributions or debt) such other foreign corporation is to avoid the application of §956 with respect to the CFC.

In 2015, IRS issued temporary regulations that toughened the anti-avoidance rule, expanded it to cover foreign partnerships controlled by the CFC, and provided rules on when a CFC is considered to derive rents and royalties in the active conduct of a trade or business for purposes of determining

FPHCI. See T.D. 9733, 09/01/2015. At the same time, IRS issued proposed regulations on whether certain property involved in transactions involving partnerships and CFCs was U.S. property for purposes of the §956 rules. See Preamble to Proposed Regulation 09/01/2015

IRS has now finalized most of the 2015 temporary and proposed regulations and has finalized portions of related 1988 proposed regulations. The final regulations make no changes to the rents and royalties rules contained in the 2015 proposed regulations, but they do make changes to several §956 rules, including the following:

a. **Anti-avoidance rule.** The 2015 temporary regulations modified the anti-avoidance rule in Regulation §1.956-1T(b)(4) so that the rule can also apply when a foreign corporation controlled by a CFC is funded other than through capital contributions or debt and expanded the rule to apply to transactions involving partnerships that are controlled by a CFC. The final regulations make the following changes:

   IRS received comments to the temporary regulations that the expanded scope of fundings could result in common business transactions being subject to the anti-avoidance rule. IRS said that whether a transaction is a "funding" does not alone determine whether the transaction is subject to the anti-avoidance rule because the rule applies only when a principal purpose of the funding is to avoid §956 with respect to the funding CFC. Thus, although the 2015 temporary regulations broaden the funding standard, the "avoidance" requirement ensures that ordinary course transactions are not subject to the anti-avoidance rule. IRS does agree, however, that examples illustrating that the anti-avoidance rule should not apply to certain common transactions would be helpful. Accordingly, the final regulations add new examples that address common transactions highlighted by the comment, to further illustrate the distinction between funding transactions that are subject to the anti-avoidance rule and common business.

   Proposed Regulation §1.956-1(b)(4) of the 2015 proposed regulations expanded the anti-avoidance rule to include transactions involving partnerships that are controlled by a CFC that provides funding to the partnership. Proposed Regulation §1.956-1(b)(4)(iii) contains a coordination rule that provides that this new partnership rule applies only to the extent that the amount of U.S. property that a CFC would be treated as holding under the rule exceeds the amount that it would be treated as holding under Proposed Regulation §1.956-4(b) (which is further discussed at "Partnership property indirectly held by a CFC partner," below). The coordination rule prevents a CFC from being treated as holding duplicative amounts of U.S. property as a result of a single partnership interest pursuant to the application of Proposed Regulation §1.956-1(b)(4) and Proposed Regulation §1.956-4(b).

   In response to a comment that Regulation §1.956-1(b)(4)(iii) should not apply at all where Regulation §1.956-4(b) applies, IRS said that, in the circumstances in which the anti-avoidance rule would apply, the funded entity, which is controlled by the CFC, essentially serves as a surrogate for the funding CFC with respect to the investment in U.S. property. Accordingly, IRS believes that, when a partnership acts as a surrogate for a CFC partner's investment in U.S. property, the CFC partner's interest in the U.S. property should not be limited to the CFC's attributable share of the property as determined under Regulation §1.956-4(b). So, IRS did not adopt this comment.

   However, the final regulations expand the coordination rule in Proposed Regulation §1.956-1(b)(4)(iii) to prevent a CFC from being treated as holding duplicative amounts of U.S. property under the anti-avoidance rule as a result of a partnership obligation (Regulation §1.956-1(b)(3)), and an additional example, Regulation §1.956-1(b)(4), is added to illustrate this rule.

b. **Factoring rules.** In 1988, IRS Proposed Regulation §1.956-3 to address the application of §956 to property acquired by a CFC in certain related party factoring transactions. The 2015 proposed regulations proposed revisions to these proposed rules in Proposed Regulation §1.956-3(b)(2)(ii) with respect to the application of §956 to acquisitions of receivables indirectly through a nominee, pass-through entity, or related foreign corporation. The final regulations adopt these portions of the 2015 proposed regulations without change and also adopt the remainder of the rules in Proposed Regulation §1.956-3 that were proposed in the 1988 proposed regulations. (Regulation §1.956-3)

c. **Partnership property indirectly held by a CFC partner.** Under Proposed Regulation §1.956-4(b)(1), a CFC partner in a partnership is treated as holding its attributable share of property held by the partnership. In addition, Proposed Regulation §1.956-4(b)(1) provides that, for purposes of §956, a partner's adjusted basis in the property of the partnership equals the partner's attributable share of the partnership's adjusted basis in the property.

Under Proposed Regulation §1.956-4(b)(2), a CFC partner's attributable share of partnership property is determined in accordance with the CFC partner's liquidation value percentage with respect to the partnership, unless the partnership agreement contains a special allocation of income (or, where appropriate, gain) with respect to a particular item or items of partnership property that differs from the partner's liquidation value percentage in a particular tax year. In that case, the partner's attributable share of the property is determined solely by reference to the partner's special allocation with respect to the property, provided the special allocation does not have a principal purpose of avoiding the purposes of §956.

The final regulations make the following changes:

Revenue Ruling 90-112, 1990-2 CB 186, covers much the same subject as Regulation §1.956-2(a)(3). However, the revenue ruling includes a limitation on the measurement of U.S. property that is not included in the final or proposed regulations. The revenue ruling provides that the amount of U.S. property taken into account for purposes of §956 when a CFC partner indirectly owns property through a partnership, is limited by the CFC's adjusted basis in the partnership. The revenue ruling is obsoleted effective November 3, 2016. For tax years ending prior to the obsolescence of the revenue ruling, taxpayers may rely on the basis limitation provided in the revenue ruling. (T.D. 9792)

Proposed Regulation §1.956-4(b)(2)(i) provides that the liquidation value percentage of partners in a partnership should be determined upon formation and upon the occurrence of events described in Regulation §1.704-1(b)(2)(iv)(f)(5) or Regulation §1.704-1(b)(2)(iv)(s)(1) (revaluation events).

Regulation §1.956-4(b)(2)(i) provides that a partner's liquidation value percentage must be redetermined in certain additional circumstances. If the liquidation value percentage determined for any partner on the first day of the partnership's tax year would differ from the most recently determined liquidation value percentage of that partner by more than 10 percentage points, then the liquidation value percentage must be redetermined on that day even in the absence of a revaluation event. For example, if the liquidation value percentage of a partner was determined upon a revaluation event to be 40% and, on the first day of a subsequent year before the occurrence of another revaluation event, would be less than 30% or more than 50% if redetermined on that day, then the liquidation value percentage must be redetermined on that day.

Proposed Regulation §1.956-4(b)(2)(ii) defines a special allocation as an allocation of income (or, where appropriate, gain) from partnership property to a partner under a partnership agreement that differs from the partner's liquidation value percentage in a particular tax year. In this regard, questions have arisen as to whether allocations pursuant to §704(c) and the regulations thereunder constitute special allocations. Although a partnership agreement may reference §704(c) or provide for the adoption of a particular §704(c) method, allocations under §704(c) are tax allocations required by operation of the Code and regulations. In response to these questions, IRS has revised the definition of special allocations in Regulation §1.956-4(b)(2)(ii) to clarify that a special allocation is an allocation of book income or gain, rather than a tax allocation such as the allocations required under §704(c).

Questions also have arisen as to whether certain allocations of income with respect to all of the property of a partnership, as opposed to allocations of income from a specific item or subset of partnership property, constitute special allocations described in Proposed Regulation §1.956-4(b)(2)(i). The final regulations clarify that, for purposes of these regulations, a special allocation means only an allocation of income (or, where appropriate, gain) from a subset of the property of the partnership to a partner other than in accordance with the partner's liquidation value percentage in a particular tax year.

For contemporaneously issued proposed regulations on treatment, for purposes of the CFC U.S. property rules, of property owned by a partnership that is controlled by a partner.

1993 legislation updated the §951 and §956 rules on the inclusion in income of U.S. property, but Regulation §1.956-1 had not been previously updated. The final regulations reflect the needed update. (Regulation §1.956-1(a))

The regulations under §954 have the same effective dates that the proposed regulations under §954 had. the "active development test" rules apply to rents or royalties received or accrued during tax years of CFCs ending on or after September 1, 2015, and to tax years of U.S. shareholders in which or with which such tax years end, but only with respect to property manufactured, produced, developed, or created, or, in the case of acquired property, property to which substantial value has been added, on or after September 1, 2015. The active marketing test rules, as well as the rules regarding cost-sharing agreements, apply to rents or royalties received or accrued during tax years of CFCs ending on or after September 1, 2015, and to tax years of U.S. shareholders in which or with which such tax years end, to the extent that such rents or royalties that are received or accrued on or after September 1, 2015. (Regulation §1.954-2(i)(2))

The §956 anti-avoidance rules in Regulation §1.956-1(b) apply to tax years of CFCs ending on or after September 1, 2015, and to tax years of U.S. shareholders in which or with which such tax years end, with respect to property acquired, including property treated as acquired as the result of a deemed exchange of property pursuant to §1001, on or after September 1, 2015.

The rules regarding factoring transactions in Regulation §1.956-3 apply to trade or service receivables acquired (directly or indirectly) after March 1, 1984.

The remaining rules apply to tax years of CFCs ending on or after November 3, 2016, and tax years of U.S. shareholders in which or with which such tax years end. See, for example, Regulation §1.956-3(b)(2)(ii) (dealing with trade and service receivables acquired from related U.S. persons indirectly through nominees, pass-through entities, or related foreign corporations).

Regulation §1.956-4(b) (dealing with partnership property indirectly held by a CFC) applies to property acquired on or after November 3, 2016.

No inference is intended as to the application of the provisions amended by these final regulations under prior law, including in transactions involving obligations of foreign partnerships.

Preamble to Proposed Regulation 11/02/2016, Proposed Regulation §1.956-4.

Contemporaneously with new final regulations (T.D. 9792), proposed regulations that would provide that a controlled foreign corporation (CFC) that is a partner in a controlled partnership determines its share of U.S. property held by the partnership in accordance with the partner's liquidation value percentage (i.e., the liquidation value percentage method), regardless of the existence of any special allocation of income or gain from the property.

For contemporaneously issued final regulations on U.S. property held by CFCs in transactions involving partnerships.

§956 is intended to prevent a U.S. shareholder of a CFC from inappropriately deferring U.S. taxation of CFC earnings and profits by preventing the repatriation of income to the U.S. in a manner which does not subject it to U.S. taxation. §956 ensures that, to the extent CFC earnings are made available for use in the U.S. or for use by the U.S. shareholder, the U.S. shareholder of the CFC is subject to current U.S. taxation with respect to such amounts. Accordingly, under §956, the investment by a CFC of its earnings and profits in U.S. property is taxed to the CFC's shareholders on the grounds that this is substantially the equivalent of a dividend. (S. Rep. No. 87-1881, 87th Cong., 2d Sess., at 88 (1962))

§956 determines the amount that a U.S. shareholder (as defined in §951(b)) of a CFC must include in gross income with respect to the CFC under §951(a)(1)(B). This amount is determined, in part, based on the average of the amounts of U.S. property held, directly or indirectly, by the CFC at the close of each quarter during its tax year. For this purpose, in general, the amount taken into account with respect to any U.S. property is the adjusted basis of the property, reduced by any liability to which the property is subject. (§956(a), Regulation §1.956-1(e))

§956(e) authorizes IRS to prescribe regulations as may be necessary to carry out the purposes of §956, including anti-avoidance rules.

Under Regulation §1.956-4(b), a CFC that is a partner in a partnership generally is treated as holding its share of U. S. property held by the partnership in accordance with the CFC partner's liquidation value percentage in the partnership. However, if there is a special allocation of income (or, where appropriate, gain) from U.S. property that does not have a principal purpose of avoiding the purposes of §956, the partner's attributable share of that property is determined solely by reference to the special allocation. (Regulation §1.956-4(b)(2)(ii))

In general, these rules provide a reasonable means of determining a partner's interest in property held by a partnership for purposes of §956 because they generally result in an allocation of specific items of property that corresponds with each partner's economic interest in that property, including any income or gain that may be subject to special allocations. However, IRS is concerned that special allocations with respect to a partnership that is controlled by a single multinational group are unlikely to have economic significance for the group as a whole and can facilitate tax planning that is inconsistent with §956 's purpose. (Preamble to Proposed Regulation 11/02/2016)

Under the proposed regulations, a partner's attributable share of each item of property of a partnership controlled by the partner would be determined solely in accordance with the partner's liquidation value percentage, even if income or gain from the property is subject to a special allocation. Thus, the exception that is otherwise available under the final regulations would not apply to a controlled partnership. under Proposed Regulation §1.956-4(b)(2)(iii), the rule in Proposed Regulation §1.956-4(b)(2)(ii) requiring a partner's attributable share of partnership property to be determined by reference to special allocations with respect to the property would not apply in the case of a partnership controlled by the partner.

For this purpose, a partner is treated as controlling a partnership if the partner and the partnership are related within the meaning of §267(b) or §707(b), substituting "at least 80 percent" for "more than 50 percent." (Proposed Regulation §1.956-4(b)(2)(iii))

The proposed regulations are proposed to be effective for tax years of CFCs ending on or after publication of the regulations as final regulations, and tax years of U.S. shareholders in which or with which such tax years end, with respect to property acquired on or after the date of publication of the final regulations. However, IRS may, where appropriate, challenge transactions under currently applicable Code or regulatory provisions or judicial doctrines.

Revenue Ruling 2017-9, 2017-21 IRB.

Guidance on the federal tax treatment of certain transactions referred to as "north-south" transactions. The ruling describes two north-south transactions, one of which involves steps that are respected as separate and another involving steps that are integrated.

Observation: In a north-south transaction, P, the parent of distributing corporation, D, may transfer assets to D before D distributes its controlled subsidiary, C, to P. Thus property is both going down (south) to D from P and up (north) to P. This ruling sheds some light on a common issue in a north-south transaction, which is whether the contribution and distribution are combined, with the result that part or all of the distribution is in exchange for the contribution.

A corporation's distribution of property to its shareholder with respect to its stock is included in the shareholder's gross income to the extent the distribution is a dividend under §316 (i.e., a distribution out of a corporation's current and accumulated earnings and profits). (§301(c)(1)) To the extent the distribution is not a dividend, the shareholder reduces basis in the distributing corporation's stock, and any amount of the distribution in excess of the shareholder's basis is treated as gain from the sale or exchange of the corporation's stock. (§301(c)(2), §301(c)(3)) If a corporation distributes appreciated assets to a shareholder in a distribution to which §301 applies, the corporation recognizes gain (but not loss) as if the property were sold to the shareholder at its fair market value (FMV). (§311(b))

Under §355(a)(1), if certain requirements are met, a corporation may distribute stock and securities of a controlled corporation to its shareholders and security holders without recognition of gain or loss (nonrecognition treatment). §355(a)(1)(A) provides that, to qualify for nonrecognition treatment, the distributing corporation must distribute stock or securities of a corporation it controls (as defined in §368(c); below) immediately before the distribution.

§355(a)(1)(D) provides in part that a distribution may qualify for nonrecognition treatment if the distributing corporation distributes an amount of stock in the controlled corporation constituting control within the meaning of §368(c). The distributing corporation and the controlled corporation each must be engaged in the active conduct of a trade or business immediately after the distribution. (§355(b)(1)(A))

No gain or loss is recognized by a corporation that is a party to a reorganization and that exchanges property solely for stock or securities of another corporation that is also a party to that reorganization. (§361(a)) If the corporation receives other property or money (boot) in addition to stock or securities, then if the corporation distributes all of the boot, it does not recognize gain on the exchange (but may recognize gain on the distribution of appreciated property). However, if the corporation does not distribute any part of the boot, gain is recognized on the exchange to the extent of the undistributed boot. (§361(b)) If the acquiring corporation distributes property other than qualified property (defined in §361(c)(2)(B)), and the FMV of such property exceeds its adjusted basis, then gain will be recognized as if such property were sold to the distributee at its FMV. (§361(c)(2)(A))

§368(a)(1)(D) includes within the definition of a reorganization a transfer by a corporation of part of its assets to another corporation if, immediately after the transfer, the transferor is in control of the corporation to which the assets are transferred and the transferor distributes the stock in a transaction that qualifies under §354, §355, or §356. "Control" under §368(c) means ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.

Under §1001(a), the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in §1011 for determining gain, and the loss is the excess of the adjusted basis for determining loss over the amount realized. The entire amount of the gain or loss under §1001 on the sale or exchange of property is generally recognized unless an exception applies. Under §1032(a), a corporation does not recognize gain or loss on the sale or exchange of its stock for money or other property. Regulation §1.1002-1(c) provides in part, with respect to §351 and §361, the underlying assumption of these exceptions to the recognition of gain or loss under §1001 is that the new property is substantially a continuation of the old investment still unliquidated; and in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old and are thus unliquidated.

In Revenue Ruling 74-79, 1974-1 CB 81, IRS ruled that §355(b)(1)(A) 's requirement that the distributing corporation be engaged in an active trade or business was satisfied where: a) the distributing corporation was an inactive holding company; and b) a subsidiary of the distributing corporation engaged in a §332 liquidation for the purpose of transferring its active trade or business to the distributing corporation.

The Tax Court, in *Estates of Bell,* TC Memo 1971-285, explained that sales of assets between a taxpayer's wholly-owned corporations followed by liquidating distributions "literally comply with the provisions of the Code dealing with complete liquidations, §331, §332, and §337, but in substance accomplish a reorganization coupled with the distribution of a dividend." The Court went on to state that, because §356 is "the exclusive measure of dividend income provided by Congress where money is distributed to shareholders as an incident of a reorganization," §301 and Regulation §1.301-1(l) were not applicable to the acquisitive reorganization under §368(a)(1)(D).

Situation 1*: P owns all the stock of D, which owns all the stock of C. The FMV of the C stock is $100X. P and C have been engaged in Businesses A and B, respectively, for more than five years, both each Business constitutes the active conduct of a trade or business within the meaning of §355(b). D is not engaged in the active conduct of a trade or business, directly or through any member of its separate affiliated group (within the meaning of §355(b)(3)) other than C.*

On Date 1, P transfers the property and activities constituting Business A, having a FMV of $25X, to D in exchange for additional shares of D stock. On Date 2, pursuant to a dividend declaration, D transfers all the C stock to P for a valid corporate business purpose. D retains the Business A property and continues the active conduct of Business A after the distribution. The purpose of P's transfer of the property and activities of Business A to D is to allow D to satisfy the active trade or business requirement of §355(b)(1)(A).

Revenue Ruling 2017-9 considers whether a transfer of property from P (including property constituting an active trade or business that is transferred for the purpose of meeting the requirements of §355(b)(1)(A)), to D, followed by, pursuant to the same overall plan, a distribution by D of the stock of C to P, should be treated for federal income tax purposes as an exchange under §351, followed by a distribution under §355.

IRS found that the facts in Situation 1 should be treated as an exchange to which §351 applies, followed by a distribution to which §355 applies.

IRS reasoned that the federal income tax consequences in Situation 1 depend on whether the Date 1 and Date 2 transfers are treated as separate transactions. Because they are undertaken pursuant to the same overall plan, a question arises as to whether the two transactions are part of a single reciprocal transfer of property-an exchange. If they are respected as separate transactions for federal income tax purposes, assuming other Code requirements are met, P would be treated as transferring property to D on Date 1 for D stock in an exchange to which §351 applies, and D would be treated as distributing all the stock of C to P on Date 2 in a distribution to which §355 applies.

However, if they are integrated into a single exchange for federal income tax purposes, P would be treated as transferring its Business A property to D in exchange for a portion of the C stock in an exchange to which §1001 applies. Gain or loss would be recognized to P on the transfer of its property to D; gain or loss would be recognized to D, under §1001(a), upon its transfer of 25% of the C stock to P in exchange for the property transferred to it. In addition, §355 would not apply to any part of the distribution of C stock because D would not have distributed stock constituting §368(c) control of C. Gain would be recognized to D, under §311(b), upon the distribution of the remaining 75% of the C stock with respect to P's stock in D to which §301 would apply.

In determining whether the transactions should be integrated, IRS noted that the tax treatment of a transaction generally follows the taxpayer's chosen form unless: (1) there is a compelling alternative policy; (2) the effect of all or part of the steps of the transaction is to avoid a particular result intended by otherwise-applicable Code provisions; or (3) the effect of all or part of the steps of the transaction is inconsistent with the underlying intent of the applicable Code provisions. (*H.B. Zachry Co.,* (1967) 49 TC 73) Looking to the intent of the Code provisions implicated in Situation 1, IRS held that the transfer of property permitted to be received by D in a nonrecognition transaction has independent significance when undertaken in contemplation of a distribution by D of stock and securities described in §355(a)(1)(A), and the transfer is accordingly respected as a separate transaction, regardless of whether the purpose of the transfer is to qualify the distribution under §355(b). IRS further noted that "[b]ack-to-back nonrecognition transfers are generally respected when consistent with the underlying intent of the applicable Code provisions and there is no compelling alternative policy." (Revenue Ruling 2015-9, 2015-21 IRB 972)

IRS concluded that P's transfer on Date 1 is the type of transaction to which §351 is intended to apply. Analysis of the transaction as a whole does not indicate that P's transfer should be properly treated other than in accordance with its form. Each step provides for continued ownership in modified corporate form. Additionally, the steps do not resemble a sale, and none of the interests are liquidated or otherwise redeemed. On these facts, nonrecognition treatment under §351 and §355 is not inconsistent with the congressional intent of these Code provisions. Accordingly, the Date 1 and Date 2 transfers described in Situation 1 will be respected as separate transactions for federal income tax purposes, so §351 applies to P's transfer on Date 1, and §355 applies to D's transfer on Date 2.

Situation 2: *P owns all the stock of D, which owns all the stock of C. D and C have been engaged in Businesses A and B, respectively, for more than five years, and each Business constitutes the active conduct of a trade or business within the meaning of §355(b).*

On Date 1, C transfers $15X of money and property having a FMV of $10X to D, pursuant to a dividend declaration, and D retains the money and property. On Date 2, D transfers to C property having a basis of $20X and a FMV of $100X, and D distributes all the C stock to P in a transaction qualifying as a reorganization under §368(a)(1)(D) and §355. C and D planned and executed the Date 1 transfer in pursuance of the plan of reorganization.

Revenue Ruling 2017-9 considers whether a transfer of money or other property by C to D, made in pursuance of a plan of reorganization under §368(a)(1)(D) and §355, is by §301 or §361.

IRS concluded §361, and not §301, applies to Situation 2.

IRS found that the tax consequences of the transaction depend on whether the two distributions are treated as separate transactions or made in pursuance of the plan of reorganization under §368(a)(1)(D) and §355. If the distribution by C of money and other property on Date 1 is treated as separate from the distribution of C stock, §301 would apply to D's receipt of the money and other property from C, and no gain would be recognized to D upon the transfer of property to C. On the other hand, if the Date 1 distribution is treated as made in pursuance of the plan of reorganization under §368(a)(1)(D) and §355 that includes the Date 2 distribution of C stock, the money and other property distributed by C to D would constitute boot to D, and, under §361(b)(1)(B), gain would be recognized to D on its transfer of property to C to the extent of the amount of the money, and the FMV of the property. §361(b) requires gain recognition to D if boot is distributed to D and not further distributed by D to its shareholders or creditors in pursuance of the plan of reorganization unless the facts establish that the distribution is in substance a separate transaction. (Revenue Ruling 71-364, 1971-2 CB 182, which held that a distribution of money declared and paid following a reorganization exchange is treated as boot in the reorganization)

As noted above, in *Estates of Bell,* the Tax Court explained that the boot rules are "the exclusive measure of dividend income provided by Congress where cash is distributed to shareholders as an incident of a reorganization." §361 broadly looks to whether transfers of money or other property occur "in pursuance of the plan of reorganization" or "in connection with the reorganization."

IRS concluded that in Situation 2, the distribution is made in pursuance of the plan of reorganization. A distribution of money and other property in pursuance of the plan of reorganization will be treated as boot subject to recognition of gain, consistent with the congressional intent underlying §361, and thus the distribution of money and property by C to D will constitute a distribution of boot under §361(b).

Revenue Ruling 2017-9 modifies Revenue Procedure 2017-3 by removing north-south transactions from the "not issuing rulings pending further guidance" area.

Revenue Ruling 2016-29, 2016-52 IRB.

When allocating housing credit dollar amounts for purposes of the low-income housing tax credit (LIHTC), §42(m)(1)(A)(ii) does not require or encourage housing credit agencies to reject any proposal that does not obtain the approval of the locality where the project developer proposes to place the project (effectively giving the locality what is known as a "local veto"). Rather, that provision merely ensures that the jurisdiction have the chance to provide local input to the allocation decision.

The LIHTC is allowed annually over a 10-year credit period beginning with the tax year a qualified low-income building is placed in service (or, if elected, the next tax year). (§42(f)) The amount of the credit for any tax year in the credit period equals the applicable percentage of the qualified basis of each "qualified low-income building." A qualified low-income building is any building that is, at all times during a statutorily prescribed period, part of a "qualified low-income housing project." (§42(c)(2))

The LIHTC for a building is limited to the housing credit dollar amount allocated to the building by a housing credit agency. (§42(h)(1)(A)) Under §42(m), every allocation of housing credit dollar amount must be made pursuant to a qualified allocation plan (QAP) that contains certain preferences and selection criteria mandated by the Code. No housing credit dollar amounts can be allocated to a building unless the allocating agency "notifies the chief executive officer (or the equivalent) of the local jurisdiction within which the building is located of such project and provides such individual a reasonable opportunity to comment on the project." (§42(m)(1)(A)(ii))

Agency, a housing credit agency in State X, is responsible for allocating housing credit dollar amounts to applicants that seek to develop affordable housing projects that will be eligible to earn LIHTCs. To guide Agency in making these allocations, Agency adopted, and the relevant governmental unit approved, a QAP.

Agency's QAP contains provisions that strongly favor applications from affordable housing projects that demonstrate affirmative local support. For example, under the point system that Agency uses in judging among applicant projects, points are granted to projects that:

a. Manifest quantifiable community participation with respect to the project, especially as evidenced by written statements from neighborhood organizations in the area of the proposed project.

b. Receive a commitment of development funding by the local political subdivision.

c. Receive community support for the application, as evidenced by a written statement from the state legislator elected from the district in which the project is proposed to be developed.

Agency believes that §42(m)(1)(A)(ii) requires that allocations be made only to proposals that receive the approval of the locality where the proposed project is to be located. Accordingly, Agency will reject an application if evidence of affirmative local support is lacking, and Agency uses factors such as the ones in its QAP to determine whether or not that support exists. Requiring local approval empowers jurisdictions to exercise what some call a "local veto."

In State X, local approval is much more likely to be secured for proposed LIHTC developments in areas with greater proportions of minority residents and fewer economic opportunities than in higher-opportunity, non-minority communities. Agency's practice of requiring local approval has created a pattern of allocating housing credit dollar amounts to projects in the predominantly lower-income or minority areas, with the result of perpetuating residential racial and economic segregation in State X.

The issue raised in the Revenue Ruling was whether, when allocating housing credit dollar amounts, §42(m)(1)(A)(ii) requires state housing credit agencies to reject any proposal that does not obtain the approval of the locality where the project developer proposes to place the project.

Although Agency believes that the local veto provisions in its QAP respond to the requirement in §42(m)(1)(A)(ii), IRS determined that Agency's interpretation is inconsistent with both the statutory language and with general Federal fair-housing policy that has been in place since well before the enactment of §42.

IRS reasoned that §42(m)(1)(A)(ii) requires that each local jurisdiction have a "reasonable opportunity" to comment on any proposal to allocate a housing credit dollar amount to a project within that jurisdiction-i.e., a chance to weigh in or object-which is not the same as requiring the jurisdiction's approval. §42(m)(1)(A)(ii) does not authorize the agency to abandon the responsibility to exercise its own judgment, and it does not require or encourage allocating agencies to bestow veto power over LIHTC projects either on local communities or on local public officials.

Agency's practice of requiring local approval has also created a pattern of allocating housing credit dollar amounts that has perpetuated residential racial segregation in State X, which has a discriminatory effect based on race and is thus inconsistent with longstanding Federal fair-housing policy.

Accordingly, IRS concluded that, in allocating housing credit dollar amounts, state agencies are neither required nor encouraged under §42(m)(1)(A)(ii) to reject all proposals that do not obtain the approval of the locality where the project developer proposes to place the project.

Revenue Procedure 2017-52, 2017-41 IRB

Pilot program expanding the scope of available letter rulings for an 18-month period to include requests for rulings on the tax consequences of a distribution of stock, or stock and securities, of a controlled corporation under §355. IRS has also provided procedures for a taxpayer to request these rulings and clarified the procedures for a taxpayer to request a ruling on significant issues relating to these transactions.

In Revenue Procedure 2013-32, 2013-28 IRB 55, IRS had announced that it would no longer rule on the tax consequences of various corporate transactions, including distributions intended to qualify under §355, but that, instead, it would rule only on significant issues raised in these transactions (Significant Issue Rulings). This policy was set out in Revenue Procedure 2017-3, 2017-1 IRB 130, §3.01(51) (before it was modified by Revenue Procedure 2017-52,).

Appendix G of Revenue Procedure 2017-3 provided that the information and representations described in Revenue Procedure 96-30, 1996-1 CB 696, as modified and amplified by Revenue Procedure 2003-48, 2003-2 CB 86 , should be included in a ruling request addressing significant issues presented in a transaction described in §355, but only to the extent related to the significant issues involved in the request. Revenue Procedure 96-30 describes information and representations that a taxpayer was required to submit in a request for a ruling under §355 prior to IRS only issuing Significant Issue Rulings in accordance with the ruling policy announced in Revenue Procedure 2013-32.

Under §355(a)(1), if certain requirements are met, a corporation (Distributing) may distribute stock, or stock and securities, of a controlled corporation (Controlled) to its shareholders or to its shareholders and security holders (Distributees), without recognition of gain or loss to, or inclusion of any amount in the income of, the Distributees.

§355(c)(1) provides that no gain or loss is recognized to Distributing upon a distribution of Controlled stock, or stock and securities, to which §355 (or so much of §356 as refers to §355) applies and which is not in pursuance of a plan of reorganization.

§368(a)(1)(D) provides, in part, that a reorganization includes a transfer by Distributing of part of its assets to Controlled if, immediately after the transfer, Distributing or one or more of the shareholders of Distributing (including persons who were shareholders immediately before the transfer) are in control of Controlled; but only if, in pursuance of the plan, stock or securities of Controlled are distributed in a transaction which qualifies under §355 or §356.

IRS has reviewed its ruling program and determined that it should be expanded in a pilot program under the terms and conditions set out in Revenue Procedure 2017-52.

Specifically, a taxpayer may request a letter ruling that addresses the general federal income tax consequences (i.e., a "Transaction Ruling") of (1) a transaction intended to qualify under §368(a)(1)(D) and §355 , or (2) a distribution that is intended to qualify under §355(a) and §355(c) (i.e., a "Covered Transaction"). (Revenue Procedure 2017-52, §2.03)

If a plan includes multiple Covered Transactions, and the taxpayer requests a Transactional Ruling with respect to one or more of the Covered Transactions, the taxpayer may request a Transactional Ruling, a Significant Issue Ruling, or no ruling with respect to each of the other Covered Transactions effected pursuant to the plan.

Revenue Procedure 2017-52 does not alter IRS's policy that limits rulings on the device prohibition under §355(a)(1)(B) and Regulation §1.355-2(d), the business purpose requirement under Regulation §1.355-2(b), and whether a distribution is pursuant to a plan under §355(e).

A Transactional Ruling may include the tax consequences of a Covered Transaction under §312, §355, §357, §358 , §361, §362(b), §362(e), §368(a)(1)(D) , §368(b), §1032(a), §1223(1) and §1223(2) , and relevant consolidated return regs. IRS may decline to rule on tax consequences under any provision of the Code or the regulations or may include rulings under provisions other than those listed above. (Revenue Procedure 2017-52, §2.03(2))

In addition, Revenue Procedure 2017-52 does not have an effect on Revenue Procedure 2017-7, 2017-1 IRB 269, which provides the current list of those areas of the Code under the jurisdiction of the Associate Chief Counsel (International) relating to matters on which IRS will not issue letter rulings or determination letters. Accordingly, routine or comfort rulings will not ordinarily be issued under the international provisions of the Code such as §367. (Revenue Procedure 2017-52, §2.03(3))

Revenue Procedure 2017-52, §3, provides the procedures for requesting a Transactional Ruling request.

Revenue Procedure 2017-52, §4, provides the procedures for requesting a Significant Ruling request. Revenue Procedure 2017-52 applies to all ruling requests , postmarked (or if not mailed, received by IRS) after September 21, 2017. (Revenue Procedure 2017-52, §6)

If a taxpayer has a request for a Significant Issue Ruling that is postmarked (or if not mailed, received by IRS) on or before September 21, 2017 (a pending ruling request), the taxpayer may convert that pending ruling request to a request for a Transactional Ruling by submitting the information and documentation required under Revenue Procedure 2017-52. All requests to convert pending ruling requests must be submitted on or before Nov. 20, 2017, and no extensions to submit a conversion request will be granted.

The pilot program under Revenue Procedure 2017-52 will expire on March 21, 2019. At that time, IRS will evaluate the effectiveness and sustainability of the program and consider whether the program should be extended.

Revenue Procedure 2017-52 will continue to apply to all ruling requests postmarked (or if not mailed, received by IRS) on or before March 21, 2019 (a submitted ruling request) if the submitted ruling request is a complete and thorough submission.

Revenue Procedure 2017-38, 2017-22 IRB.

IRS has modified the Revenue Procedure that sets outs areas of the Code in which it will not issue letter rulings or determination letters (no-rule areas) to provide that, on and after May 9, 2017, IRS will rule on whether §355 or §361 applies to a corporation's distribution of stock or securities of a controlled corporation in exchange for, and in retirement of, any putative debt of the distributing corporation if that debt is issued in anticipation of the distribution.

Generally, §355 provides that, if certain requirements are satisfied, a distributing corporation may distribute the stock (or stock and securities) of a controlled corporation to its shareholders and security holders without the distributing corporation, its shareholders, or its security holders recognizing income, gain, or loss on the distribution. Various requirements must be satisfied for §355 to apply to a distribution.

In the interest of sound tax administration, IRS answers written inquiries from individuals and organizations on the tax effects of their acts or transactions by issuing letter rulings or determination letters. However, there are areas in which IRS will not issue letter rulings or determination letters because the issues are inherently factual or for other reasons. IRS publishes guidance setting out these no-rule areas from time to time and incorporates them annually into a Revenue Procedure. (Revenue Procedure 2017-3, 2017-1 IRB 130)

Revenue Procedure 2017-3, §5, provides a list of the areas under study in which rulings or determination letters will not be issued until IRS resolves the issue through publication of a Revenue Ruling, a Revenue Procedure, regulations, or otherwise. Revenue Procedure 2017-3, §5.01(4), provides that IRS will not issue a ruling on whether either §355 or §361 applies to a distributing corporation's distribution of stock or securities of a controlled corporation in exchange for, and in retirement of, any putative debt of the distributing corporation if such distributing corporation debt is issued in anticipation of the distribution.

IRS has deleted Revenue Procedure 2017-3, §5.01(4), along with another section (Revenue Procedure 2017-3, §5.01(6)) that cross-referenced Revenue Procedure 2017-3, §5.01(4). Accordingly, IRS will now rule on whether §355 or §361 applies to a corporation's distribution of stock or securities of a controlled corporation in exchange for, and in retirement of, any putative debt of the distributing corporation if that debt is issued in anticipation of the distribution.

While IRS continues to study this area, it has determined that issuing private letter rulings or determination letters in this area would be in the interest of sound tax administration.

Revenue Procedure 2017-28, 2017-14 IRB.

Guidance to employers on the requirements for employee consents used to support a claim for refund of overpaid Federal Insurance Contributions Act (FICA) or Railroad Retirement Tax Act (RRTA) taxes. The Revenue Procedure allows employee consents to be requested, furnished, and retained in an electronic format as an alternative to a paper format, and also contains guidance concerning what constitutes "reasonable efforts" if an employee consent is not secured as part of the process of permitting the employer to claim a refund of the employer share of overpaid FICA taxes.

In general, employers may choose to correct FICA tax overpayment errors by either making an interest-free adjustment or filing a claim for refund. Regulation §31.6402(a)-2 provides the rules under which a refund claim for an overpayment of FICA tax may be made. An employer may not receive a refund of the employer share of overpaid FICA tax without making reasonable efforts to protect its employee's interests. (Regulation §31.6402(a)-2, Revenue Ruling 81-310, 1981-2 CB 241)

Regulation §31.6402(a)-2(a)(1)(ii) specifically provides that no refund for the employer share of the overpaid FICA taxes will be allowed unless the employer has first repaid or reimbursed its employee or has secured the employee's consent to the allowance of the claim for refund and includes a claim for the refund of such employee tax. Regulation §31.6402(a)-2(a)(2) generally requires the employer to certify, as part of the claim process, that the employer has repaid or reimbursed the employee share of the overpayment of FICA tax to the employee or has secured the written consent of the employee to allowance of the refund or credit.

For refund claims for employee tax overcollected in prior years, the employer must also certify that it has obtained the employee's written statement confirming that the employee has not made any previous claims (or the claims were rejected) and will not make any future claims for refund or credit of the amount of the overcollection.

These requirements do not apply to the extent that the taxes were not withheld from the employee. Nor do they apply if, after the employer's reasonable efforts to obtain the employee's consent (including any required written statement), the employer cannot locate the employee or the employee does not furnish either the employee consent or a response indicating that the employee is not authorizing the employer to claim a refund of FICA taxes on his behalf. In these cases, the employer may claim a refund of the overpaid employer share of the tax but may not obtain a refund of the employee share.

The employer must retain each employee's consent, including any written statement, as part of its records. (Regulation §31.6402(a)-2(a)(2)(i)) An employer that claims a refund must also retain a complete and detailed record with respect to the tax to which the claim relates, including a copy of any statement or other documents, for as long as the contents of the statement or document may become material (at least four years after the date the claim is filed). (Regulation §31.6001-1; Regulation §31.6001-2)

In Notice 2015-15, 2015-9 IRB 687, IRS published a proposed Revenue Procedure and requested comments on it.

The 2015 proposed Revenue Procedure is adopted, with minor changes, in Revenue Procedure 2017-28. It provides guidance to employers on employee consents used to support a claim for refund under §6402 and Regulation §31.6402(a)-2 for overpaid FICA taxes; clarifies the basic requirements for a request for a consent and for the employee consent itself, including the requirement that an employee consent must include the basis for the claim for refund and be signed by the employee under penalties of perjury; and permits, but does not require, employee consent to be requested, furnished, and retained in an electronic format as an alternative to a paper format. It also contains guidance concerning what constitutes "reasonable efforts" if an employee consent is not secured in order to permit the employer to claim a refund of the employer share of overpaid FICA taxes.

The principal changes from the proposed Revenue Procedure are:

a. Shortening the time to respond to a second request for consent from 45 to 21 days.

b. Permitting the use of a truncated taxpayer identification number (TTIN) in place of the complete social security number (SSN) of the employee if the employer prepares a consent for the employee to sign and pre-populates the employee's taxpayer identification number with the TTIN. A TTIN may not be used, however, if the employer merely requests that the employee provide an SSN as the employee's taxpayer identification number or if the employee furnishes the number via the consent.

c. Adding a new requirement that all requests for consent must indicate that an employee cannot authorize the employer to claim a refund on the employee's behalf for any overpaid Additional Medicare Tax under §3101(b)(2). (Revenue Procedure 2017-28, §2)

Revenue Procedure 2017-28 permits an employer to request, furnish, and retain employee consents in an electronic format. (Employees must also be given the option to provide the employee consent in a paper format; employers may retain these paper consents electronically.)

The request must clearly inform the employee of the purpose of the employee consent and provide a reasonable period of time for the employee to respond (defined as not less than 45 days from the date of the request). A request for a consent may include an express presumption that if an employee's response has not been received by the employer during this time period, the employee will be considered to have refused to provide the employee consent. In no case, however, may a failure to respond be deemed consent. A request must clearly state that the employee will be repaid or reimbursed the employee share of the overpayment (plus any interest allocable to the employee share) to the extent it is refunded by IRS. Finally, all requests for consent must indicate that an employee cannot authorize the employer to claim a refund on the employee's behalf for any overpaid Additional Medicare Tax, regardless of whether Additional Medicare Tax was withheld from the employee. Sample language to that effect is provided. (Revenue Procedure 2017-28, §6.01)

The employer may furnish a paper request for a consent by personal delivery or by mail to the employee's last known address by the United States Postal Service or a designated delivery service under §7502(f), or send an electronic request for a consent to the employee's email address in accordance with Revenue Procedure 2017-28, §6.02.

The consent must include certain identification information for both the employee and employer; the tax period, type of tax, and amount of tax for which the consent is provided; an affirmative statement that the employees authorizes the employer to claim a refund for the overpayment of the employee share, as well as a written statement for refund claims for employee tax overcollected in prior years; the basis of the claim; and the date and signature, under penalties of perjury. (Revenue Procedure 2017-28, §6.03) The employer may use a TTIN on an employee consent as the employee's taxpayer identification number in limited circumstances. (Revenue Procedure 2017-28, §6.03)

An employer is permitted to establish an electronic system to request, furnish, and retain employee consents, including allowing employees to submit an employee consent by fax. It also permits the retention in an electronic format of requests and employee consents submitted in a paper format. The rules for furnishing and retaining employee consents also apply to an employee's response indicating that the employee does not authorize the employer to claim a refund of FICA taxes on his or her behalf. (Revenue Procedure 2017-28, §7.01)

The electronic system must be reasonably accessible to the employee and must be reasonably designed to preclude anyone other than the employee from giving the employee consent. It must provide the electronic request for a consent to the employee in a manner no less understandable than a written paper document. (Revenue Procedure 2017-28, §7.02)

Electronic records and signatures are given the same legal effect as their paper counterparts. Revenue Procedure 2017-28, §7.04 sets out a number of requirements for what constitutes, pending further guidance, an acceptable electronic signature.

Generally, if the employer has not repaid or reimbursed an employee, a refund for the employer share of the overpaid FICA taxes will not be allowed unless the employer has both secured the employee's consent and included a claim for the refund of the employee. However, these requirements do not apply to the extent that the taxes were not withheld from an employee or, after the employer makes reasonable efforts to repay or reimburse the employee or secure the employee's consent, the employer cannot locate the employee or the employee will not provide consent. The employer can show that the employee will not provide the requested consent if the employee does not respond to the employer's request for consent or if the employee provides a response that indicates that the employee does not authorize the employer to claim a refund of FICA taxes on his or her behalf. (Revenue Procedure 2017-28, §8.01)

The employer will be deemed to have made reasonable efforts with respect to a request for a consent if:

a. The employer properly requests a consent of the employee as provided in Revenue Procedure 2017-28;

b. A request for a consent sent electronically provides for an acknowledgement of receipt of the email message. The request must specifically ask the employee to acknowledge receipt of the request for a consent (e.g., by clicking on a voting button (YES) or by sending a reply message to the employer);

c. The employer retains a record of mailing the request for a consent, record of emailing the request for a consent (including acknowledgement of receipt of the email message), record of personal delivery to the employee who does not furnish an employee consent, or the employee's response indicating that the employee was not authorizing the employer to claim a refund of FICA taxes on his behalf;

d. In the event the mailing is undeliverable, the employer makes an effort to determine the employee's current address and, if a new address is discovered, the employer delivers a request for a consent in a paper format to the new address or delivers a request for a consent by email or by personal delivery, giving the employee not less than 21 days from the date of the request to reply to the subsequent request; and

e. In the event of an email delivery failure (e.g., the employer is notified that the message the employer tried to send did not reach the employee because of a problem with the email address) or in the event that the employee does not acknowledge receipt of the email message, the employer mails a request for a consent in a paper format to the employee's last known address or provides a request for a consent to the employee by personal delivery giving the employee not less than 21 days from the date of the request to reply to the subsequent request. (Revenue Procedure 2017-28, §8.02)

Revenue Procedure 2017-28 applies to employee consents requested on or after June 5, 2017. It does not require employers to solicit new employee consents and will not affect the validity of any employee consent received pursuant to a request made prior to June 5, 2017, that was provided in accordance with the requirements in Regulation §31.6402(a)-2. Employers may rely on the proposed revenue procedure for employee consents requested before that date.

Revenue Procedure 2017-14, 2017-3 IRB.

Detailed the requirements for a certified professional employer organization (CPEO) to remain certified and the procedures relating to suspension and revocation of CPEO certification. In addition, IRS has provided guidance, including certain transition relief, to CPEOs with an effective date of certification of January 1, 2017, that receive notice of certification after that date. The Revenue Procedure is effective December 29, 2016.

Small businesses often contract with professional employer organizations (PEOs), also known as employee leasing companies, to ensure compliance with workplace laws and regulations. In the typical contract, the PEO computes the FICA, withholding tax, worker's compensation, and 401(k) contributions of each employee and bills the client for the amount. The contract requires the PEO to pay the employees and make the clients' tax deposits. Some PEOs file their client companies' employment tax returns under the PEO's name and list the PEO as the employer of the client companies' employees.

Before enactment of the Tax Increase Prevention Act of 2014 (TIPA, P.L. 113-295, 12/19/2014), when a business contracted with a PEO to administer its payroll functions, the business customer remained responsible for all withholding taxes with respect to its employees. Thus, even though the PEO paid the employees, the customer remained liable if the PEO failed to withhold or remit the taxes or otherwise comply with related reporting requirements.

Effective for wages for services performed on or after January 1, 2016, §3511, as added by TIPA, allows a CPEO to be treated as the sole employer of the employees.

A CPEO is an organization that has been certified by IRS as meeting certain requirements, which are intended to ensure that the PEO properly remits wages and employment taxes.

The certification was initially required under TIPA to be established by July 1, 2015, but IRS needed additional time to set it up and delayed the date that it would begin accepting applications for PEO certification until July 1, 2016.

In May, 2016, IRS issued temporary regulations that set out the requirements a person must satisfy in order to become and remain a CPEO. And, in June, 2016, IRS issued Revenue Procedure 2016-33, 2016-25 IRB 1034, which contains the procedures for applying for certification as a CPEO.

In August of 2016, IRS announced the liberalization of rules that it promulgated in the May, 2016 temporary regulations and Revenue Procedure 2016-33, regarding requirements for becoming certified as a CPEO. (Notice 2016-49, 2016-34 IRB 265)

In Revenue Procedure 2017-14, IRS details the requirements for a CPEO to remain certified and the procedures relating to suspension and revocation of its CPEO certification. Revenue Procedure 2017-14 includes certain transition relief, to CPEOs with an effective date of certification of January 1, 2017, that receive notice of certification after that date. In addition, Revenue Procedure 2017-14 consolidates in one place the ongoing requirements articulated in the proposed and temporary regulations under §3511 and §7705, as well as certain applicable requirements of Revenue Procedure 2016-33, as modified by Notice 2016-49.

Revenue Procedure 2017-14 provides that to maintain certification, a CPEO must meet the applicable requirements described in Regulation §301.7705-2T, Revenue Procedure 2017-14, and other guidance. In addition, any responsible individuals of the CPEO must meet any requirements applicable to them that are described in Regulation §301.7705-2T, Revenue Procedure 2017-14, and other guidance. (Revenue Procedure 2017-14, §2.02(1))

Except as otherwise provided in Revenue Procedure 2017-14 or other guidance, the information and documents required in Revenue Procedure 2017-14, §2.02, through Revenue Procedure 2017-14, §2.05, Revenue Procedure 2017-14, §2.06(3), and Revenue Procedure 2017-14, §2.06(4) must be submitted electronically via the online account created by the CPEO or responsible individual, as applicable. The individual submitting information and documents on behalf of the CPEO through the CPEO's online account must be authorized by §6103(e) to inspect the returns and return information of the CPEO. (Revenue Procedure 2017-14, §2.01)

Consistent with Regulation §301.7705-2T(j), a CPEO must submit a properly completed and executed online annual verification to maintain certification. CPEOs that are members of a controlled group must each submit a separate annual verification. The due date for submitting the annual verification is 30 days before the anniversary of the date (month and day) on which the CPEO's certification became effective. (Revenue Procedure 2017-14, §2.02(1))

Consistent with §7528(b)(4), upon submission of the online annual verification, the individual that submits the verification on behalf of the CPEO will be automatically directed to pay a user fee in the amount of $1,000. Payment confirmations are provided. No CPEO annual verification will be processed until a user fee in the amount of $1,000 is received. Once processing of the annual verification has begun, the user fee will not be returned. (Revenue Procedure 2017-14, §2.02(2))

As part of a CPEO's annual verification, IRS may investigate the accuracy of statements and representations made by a CPEO and its responsible individuals by conducting background checks, including checks on tax compliance, criminal background, professional experience, credit history, professional sanctions, and other relevant facts. By submitting an annual verification, a CPEO and its responsible individuals agree to provide IRS with such additional information as it may request to facilitate its background investigations.

A CPEO and each of its responsible individuals must take such actions as are necessary to authorize IRS to conduct background checks and to investigate the accuracy of statements and submissions. This may include waiving confidentiality and privilege in situations in which IRS would otherwise be prevented from obtaining or confirming information necessary to evaluate a CPEO's qualification for certification from relevant third parties (such as former employers) because of the existence of confidentiality, non-disclosure, or similar agreements. Failure to provide such information or take such action may result in revocation of certification. (Revenue Procedure 2017-14, §2.02(3))

In addition to the bond that must be posted within 30 days of the notice of certification under §7705(c), Regulation §301.7705-2T(g), and Revenue Procedure 2016-33, §2.04(2), a CPEO must continue to post a bond (or bonds, as described in Revenue Procedure 2017-14, §2.03(3)), from a qualified surety for the payment of federal employment taxes using Form 14751, Certified Professional Employer Organization Surety Bond, in the amount described in Regulation §301.7705-2T(g)(2) and Revenue Procedure 2017-14, §2.03, for each period beginning on April 1 of any calendar year and ending on March 31 of the following calendar year (the bond period). As prescribed by Regulation §301.7705-2T(g)(2)(i), the amount of the bond (or bonds, as described in Revenue Procedure 2017-14, §2.03(3)) with respect to the bond period must be at least equal to the greater of 5% of the CPEO's liability under §3511 during the preceding calendar year (up to $1 million) or $50,000. (Revenue Procedure 2017-14, §2.03(1))

IRS may suspend and/or revoke the certification of any CPEO as a result of one or more failures to comply with any of the requirements for CPEOs described in §3511 and §7705, their regulations, Revenue Procedure 2016-33, Notice 2016-49, Revenue Procedure 2017-14, and any other guidance issued by IRS applicable to CPEOs. IRS will do so if IRS determines, in its sole discretion and based on a review of the relevant facts and circumstances, that one or more of such failures present a material risk to IRS's collection of federal employment taxes.

Revenue Procedure 2017-14, §3.02, provides examples of specific failures that may result in the issuance of a notice of suspension and proposed revocation, the consequences of which are described in Revenue Procedure 2017-14, §3.03(1). CPEO may request review of the proposed revocation, in the manner described in Revenue Procedure 2017-14, §3.03(2), which may result in the lifting of the suspension or the issuance of a notice of final revocation. Consequences of revocation of certification are described in Revenue Procedure 2017-14, §3.09. (Revenue Procedure 2017-14, §3.01)

Specific circumstances that may result in suspension and proposed revocation of certification include, but are not limited to:

1. A failure to timely complete an annual verification, timely submit annual audited financial statements and an accompanying CPA opinion, or timely submit a quarterly assertion, attestation, or working capital statement, as provided in Revenue Procedure 2017-14, §2.02, Revenue Procedure 2017-14, §2.04, and Revenue Procedure 2017-14, §2.05;

2. A failure to maintain a bond or bonds in the required bond amount, as provided in Revenue Procedure 2017-14, §2.03;

3. A failure to satisfy the reporting requirements provided in Revenue Procedure 2017-14, §2.06, including a failure of the CPEO or a responsible individual of the CPEO to notify IRS of a material change, as provided in Revenue Procedure 2017-14, §2.06(3), and Revenue Procedure 2017-14, §2.06(4);

4. The charging or conviction of the CPEO, or a related entity or a responsible individual of the CPEO, with or for any criminal offense under the laws of the U.S. or a state or political subdivision;

5. The CPEO, or a related entity or a responsible individual of the CPEO, being the subject of an active IRS criminal investigation;

6. A failure (other than an immaterial and isolated failure that does not reflect a meaningful lapse in compliance with federal employment tax withholding and deposit requirements) by the CPEO or any responsible individual to pay any applicable federal, state, or local taxes or file any required federal, state, or local tax or information returns in a timely and accurate manner, unless the failure is determined to be due to reasonable cause and not due to willful neglect;

7. The assessment of fraud penalties against the CPEO or any of its responsible individuals or related entities by the IRS or another tax authority; and

8. The discovery of any errors or omissions in any annual audited financial statements or working capital statements previously submitted to IRS in accordance with Revenue Procedure 2017-14, §2.04 Revenue Procedure 2017-14, §2.05, Revenue Procedure 2016-33, §2.05, Revenue Procedure 2016-33, §2.06, Regulation §301.7705-2T(e) and Regulation §301.7705-2T(f), that would require a restatement of previously submitted statements. (Revenue Procedure 2017-14, §3.02)

Revenue Procedure 2017-14, §5.01, provides transition relief for newly certified CPEOs that are certified with an effective date of January 1, 2017. with respect to both the bond period from January 1, 2017, to March 31, 2017, and the bond period from April 1, 2017, to March 31, 2018, such a CPEO will be required to submit only one properly completed and executed Form 14751 covering both bond periods. The single bond posted using this Form 14751 must have an effective date of January 1, 2017, and cover both bond periods using the same bond amount, which is in the amount required by Regulation §301.7705-2T(g)(2), calculated for the bond period beginning April 1, 2017, and ending March 31, 2018. In addition, the CPEO will have 30 days from the date of its notice of certification to submit this Form 14751, without regard to when the CPEO's notice of certification is received.

CCA 201726012.

The transfer of a partnership interest in a complete liquidation to which §332(a) applied or in a reorganization to which §368(a)(1)(A) (Type A reorganization) and/or §368(a)(1)(D) (Type D reorganization) applied was a transfer by sale or exchange for purposes of §743(b). Further, IRS determined that §743(b) adjustments were not subject to reallocation under §704(b) because they were personal to the transferee and did not affect common basis.

Under §704(b), a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) is to be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocation to a partner under the agreement of such items does not have substantial economic effect.

Regulation §1.704-1(b)(2)(iv)(m)(2) provides, in relevant part, that in the case of a transfer of all or a part of an interest in a partnership that has a §754 election in effect for the partnership tax year in which the transfer occurs, adjustments to the adjusted tax basis of partnership property under §743 will not be reflected in the capital account of the transferee partner or on the books of the partnership, and later capital account adjustments for distributions and for depreciation, depletion, amortization, and gain or loss with respect to such property will disregard the effect of such basis adjustment.

§743(b) provides, in relevant part, that in the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which the election provided in §754 (dealing with an optional adjustment to basis of partnership property) is in effect or which has a substantial built-in loss immediately after such transfer will (1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his or her interest in the partnership over his or her proportionate share of the adjusted basis of the partnership property, or (2) decrease the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his or her interest in the partnership.

Under regulations, such increase or decrease will constitute an adjustment to the basis of partnership property with respect to the transferee partner only. A partner's proportionate share of the adjusted basis of partnership property will be determined in accordance with its interest in partnership capital and, in the case of property contributed to the partnership by a partner, §704(c) (dealing with contributed property) will apply in determining such share.

Regulation §1.743-1(j)(1) provides that the basis adjustment constitutes an adjustment to the basis of partnership property with respect to the transferee only. No adjustment is made to the common basis of partnership property. Thus, for purposes of calculating income, deduction, gain, and loss, the transferee will have a special basis for those partnership properties the bases of which are adjusted under §743(b) and its regulations. The adjustment to the basis of partnership property under §743(b) has no effect on the partnership's computation of any item under §703.

§761(e) provides that, except as otherwise provided in regulations, for purposes of (a) §708 (relating to continuation of partnership), (b) §743 (relating to optional adjustment to basis of partnership property), and (c) any other provision of subchapter K specified in regulations prescribed by IRS, any distribution of an interest in a partnership (not otherwise treated as an exchange) will be treated as an exchange.

In Year 1, unrelated Parent 1 and Parent 2 formed a joint venture to combine the operations of each of their Businesses under Brand name.

In Year 2, Parent 1 and 2, indirectly through Partnership 1, acquired the outstanding stock of unrelated Corporation 1 for cash. Partnership 1 formed Corporation 2 as an acquisition vehicle. Subsidiary D, an indirect subsidiary of Parent 2, and Subsidiary E, an indirect subsidiary of Parent 1, made cash contributions to Partnership 1 in exchange for membership interests in Partnership 1. Partnership 1 then contributed this cash to Corporation 2, which was used to acquire the outstanding stock of Corporation 1, via a merger of Corporation 1 into Corporation 2. Later in Year 2, Partnership 1 formed a lower-tier partnership, Partnership 2, to hold the combined Business assets of Partnership 1 and Corporation 2.

In Year 3, Parent 2 acquired Corporation 3 for cash, and Parent 2's name was changed to Taxpayer. Taxpayer continued to be the common parent of the Taxpayer Group, which now included Parent 1 and the former members of Parent 1's consolidated group.

In Year 6, Partnership 1 partially redeemed the membership interests held by Subsidiary B and Subsidiary C. Partnership 1 distributed a percentage of its Corporation 2 stock to these distributee partners. After the partial redemption, Corporation 2 became a member of the Taxpayer Group. At the time of the partial redemption, both Partnerships 1 and 2 had §754 elections in place.

In Year 9, the Taxpayer Group engaged in another restructuring of its corporate subsidiaries engaged in Business. At this time, Subsidiary B was owned by Subsidiary G and Subsidiary H. Subsidiary B distributed cash to Subsidiary G in redemption of its stock, and then merged upstream into Subsidiary H in a transaction purported to qualify as a §332 complete liquidation. Immediately thereafter, Subsidiary H merged sideways into Subsidiary F in a transaction purported to qualify as a reorganization under §368(a)(1)(A) and §368(a)(1)(D) (the Reorganization). Neither Subsidiary B nor Subsidiary H recognized an amount of gain or loss with respect to their transfers of the interest in Partnership 1, and Subsidiary H and Subsidiary F took a basis in the interest equal to that of the respective transferor.

Subsidiary C, which was wholly owned by Subsidiary E, merged upstream into Subsidiary E in a transaction purported to qualify as a §332 complete liquidation (the Liquidation). Subsidiary C recognized no amount of gain or loss with respect to its transfer of its interest in Partnership 1, and Subsidiary E took a basis in the interest equal to that of the transferor, Subsidiary C. Finally, Subsidiary A distributed its interest in Partnership 1 to Subsidiary E, in a distribution to which §301 and §311(b) applied (the Distribution).

Partnerships 1 and 2 each had §754 election in place at the time of the Year 9 transactions. Accordingly, the Taxpayer Group took the position that the Reorganization, the Liquidation, and the Distribution resulted in transfers of partnership interests that were considered transfers by sale or exchange under §743(b). The transfers, including those pursuant to the purported nonrecognition transactions, therefore triggered a step-up in basis of partnership assets owned by Partnership 1 and its lower-tier partnership, Partnership 2. The Taxpayer Group calculated a net §743(b) adjustment for the transfers of Partnership 1 interests pursuant to the Reorganization and the Liquidation. The Taxpayer Group also calculated a net §743(b) adjustment for the indirect transfers of Partnership 2 pursuant to such transactions.

IRS determined that the transfer of a partnership interest in a complete liquidation or in a Type A and/or Type D reorganization was a transfer by sale or exchange for purposes of §743(b). IRS also found that §743(b) adjustments were not subject to reallocation under §704(b) because they were personal to the transferee and did not affect common basis.

IRS reasoned that the §761 regulations do not limit the definition of "exchange" to taxable exchanges for purposes of §743. In particular, no provisions limit the definition of an exchange between related parties or members of a consolidated group. The transactions at issue here involved the distribution of a partnership interest as part of the complete liquidation of a corporate partner, and the transfer of a partnership interest as part of the reorganization of a corporate partner. Consequently, these transactions constituted an exchange for purposes of §743 under §761(e).

Partnerships 1 and 2 each had a §754 election in effect for Year 9. As noted above, the Year 9 transactions were sales or exchanges for purposes of §743(b). As a result, IRS determined that Partnerships 1 and 2 were required to adjust the basis of the partnership property with respect to transferees as required by §743(b) and its regulations. Adjustments to the adjusted tax basis of partnership property under §743 were not to be reflected in the capital account of the transferee partner or on the books of the partnership pursuant to Regulation §704-1(b)(2)(iv)(m)(2). And, no adjustment was to be made to the common basis of partnership property, and the §743(b) adjustment had no effect on the partnership's computation of any item under §703 pursuant to Regulation §1.743-1(j)(1). §743(b) adjustments were personal to the transferee partners and were not subject to reallocation under §704(b).

Chief Counsel Advice 201721015.

The regulatory authority in §163(j) -which provides that IRS may prescribe such regulations as may be appropriate to carry out §163(j) 's purpose-was not self-executing.

§163(j) was added by the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) to prevent erosion of the U.S. tax base by means of excessive deductions for interest paid by a taxable corporation to a tax-exempt (or partially tax-exempt) related person. The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) broadened the scope of §163(j) to apply to interest paid with respect to certain loans between unrelated parties.

In general, §163(j) operates to disallow the deduction of interest paid or accrued by a U.S. corporation to a related person (defined in §163(j)(4)), if:

1. The U.S. corporation paying or accruing the interest has a debt-to-equity ratio greater than 1.5 to 1 on the last day of the tax year. (§163(j)(2)(A)(ii), §163(j)(2)(C), Proposed Regulation §1.163(j)-1(b), and Proposed Regulation §1.163(j)-3);

2. The recipient of the interest income is shielded from U.S. taxation on some portion of the income (i.e., the "disqualified interest," which includes non-taxed and treaty-favored interest). (§163(j)(3) and Proposed Regulation §1.163(j)-4); and

3. The U.S. corporation's "net interest expense" (defined in §163(j)(6)(B)) exceeds the sum of (i) 50% of its "adjusted taxable income," and (ii) any "excess limitation carryforward" from the three proceeding years (i.e., the "excess interest expense," which is high in comparison to income). (§163(j)(2)(B)) Adjusted taxable income is the taxpayer's taxable income computed without regard to: any deduction allowable for the net interest expense; the amount of any net operating loss deduction; any domestic production activities deduction; and any deduction allowable for depreciation, amortization, or depletion, computed with such other adjustments "as the Secretary may by regulations prescribe." (§163(j)(6)(A)) In defining excess limitation carryforward, "excess limitation" is the excess (if any) of 50% of the adjusted taxable income of the corporation, over the corporation's net interest expense. (§163(j)(2)(B)(iii))

In addition, a foreign corporation that has income, gain or loss that is effectively connected (or is treated as effectively connected) with the conduct of a trade or business in the U.S. for the tax year may be subject to the §163(j) rules for the tax year. (Proposed Regulation §1.163(j)-8)

Furthermore, the §163(j) rules apply to certain guaranteed third-party loans. They apply to interest that is paid or accrued to an unrelated person if there is a "disqualified guarantee" on the underlying debt and no gross basis tax (as defined in §163(j)(6)(E)) is imposed on such interest. (§163(j)(3)(B) and §163(j)(6)(D))

The amount of interest expense that is disallowed as a deduction under §163(j) (the "disallowed interest") is carried over to the following tax year. (§163(j)(1)(B))

§163(j)(9) provides that "the Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this subsection," including:

a. Such regulations as may be appropriate to prevent the avoidance of the purposes of §163(j);

b. Regulations providing such adjustments in the case of corporations which are members of an affiliated group as may be appropriate to carry out the purposes of §163(j);

c. Regulations for the coordination of §163(j) with §884 (dealing with the branch profits tax); and

d. Regulations providing for the reallocation of shares of partnership indebtedness, or distributive shares of the partnership's interest income or interest expense.

In June 1991, the Treasury Department and IRS issued proposed rules implementing §163(j), but they have yet to be finalized.

Observation: A tax statute is self-executing (i.e., does not require regulations as a prerequisite to being effective) if the regulations referred to in the statute deal only with how, not whether, the tax is to be applied. In the case of "how" regulations, Congress states what a particular rule is to provide, and articulates the overall purpose of the statute in the legislative history, but leaves the mechanics or details affecting the application of the statute to IRS, with the result that the regulations only constitute a means of arriving at "how" that rule, otherwise imposed by statute, should be applied.

Observation: A statute is not self-executing, however, if "whether" regulations are required. That is, the promulgation of regulations is a necessary condition for determining "whether" the statute applies in the first place. (*Neumann*, (1996) 106 TC 216) To determine whether a statute is self-executing, courts have looked for explicit language supporting such a conclusion, have considered legislative history, and have considered whether the statute can be applied without further explication in a Regulation (*Temsco Helicopters, Inc. v. U.S.*, (CA 9 2010) 106 AFTR 2d 2010-6564)

In *International Multifoods Corp*, (1997) 108 TC 579, the taxpayer was allowed to source a loss in accordance with the statutory rule in §865(a) where despite a statutory provision that "The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purpose of this section, including regulations... relating to the treatment of losses from sales of personal property," no loss sourcing regulations were issued. The Tax Court found that the absence of regulations was not an acceptable basis for refusing to apply the substantive provisions of a Code section.

In *15 West 17th Street LLC*, (12/22/2016) 147 TC No. 19, the Tax Court held that the rule of §170(f)(8)(D) -which provides a waiver of the requirement that a charitable donor secure and maintain a contemporaneous written acknowledgment from the donee with respect to certain information if the donee files a return with that information "on such form and in accordance with such regulations as the Secretary may prescribe"-did not currently apply because IRS had not yet issued such regulations. Accordingly, the taxpayer, who failed to satisfy the contemporaneous written acknowledgment requirement, could not take a charitable contribution deduction where the donee filed an amended Form 990 with information about the taxpayer's donation.

In *15 West 17th Street*, the Court noted that cases that found Code sections to be self-executing where they provided that the Secretary ''shall prescribe regulations,'' have generally dealt with a provision's taxpayer-friendly character. In addressing §931(d)(2), which provides that the determination as to whether certain income is possessions-source income "shall be made under regulations prescribed by the Secretary," the Tax Court held the statute to be self-executing despite the absence of regulations, noting the principle "that the Secretary's failure to issue regulations does not bar application of a beneficial tax statute." (*Francisco,* 119 TC 317)

In *Hillman, et ux.,* (2000) 114 TC 103, the Tax Court noted that where regulations are necessary to implement a statutory scheme providing favorable taxpayer rules, the Court has found that the statute's effectiveness was not conditioned upon the issuance of regulations. The Code section at issue, §469(1)(2), provided that "the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out" §469. The Tax Court found that IRS's position denying the offset to the taxpayers was contrary to the legislative history and intent of Congress, and appeared to be based on no established tax policy or any reason other than the failure to promulgate a Regulation However, in *Hillman v. U.S.,* (CA 4 2001) 88 AFTR 2d 2001-5292, the Fourth Circuit reversed the Tax Court's decision for the taxpayer, finding that his position was not supported by the statutory language and that the legislative history, which when read more closely, did not clearly express the congressional intent suggested with regard to the taxpayer's particular case. Further, the Fourth Circuit noted that the legislative history stated without qualification, that the Secretary had discretion to identify situations in which offsetting otherwise prohibited under §469(a) would be allowed.

In the email CCA, IRS concluded that the regulatory authority in §163(j) was permissive in a way that was similar to §170(f)(8)(D) and allowed for (but did not require) a discretionary exercise of rulemaking authority. Given the nature of the rulemaking authority in §163(j), IRS was comfortable with the examiner's conclusion that the statute was clear and controlled the outcome. Further, IRS found that the examiner's reliance on Hillman was appropriate, particularly in light of the permissive language of the statute and the lack of an indication in the legislative history that Congress intended IRS to modify the definition of adjusted taxable income, let alone to modify it to include the items at issue in the instant case.

In reaching this conclusion in 15 West 17th Street, the Tax Court had cited Hillman and reasoned that a court's usual role was to review the regulations that an agency has issued, not to conjure what regulations might look like had they been promulgated. In addition, the Court emphasized that the language in §170(f)(8)(D) was a permissive delegation of rulemaking authority and the fact that there were no cases in which the language "may prescribe" resulted in a finding of a self-executing statute. The Court also found that the legislative history of the provision did not indicate a self-executing statute because it acknowledged concerns associated with donee returns.

In the CCA, IRS noted that in *15 West 17th Street*, the Tax Court majority opinion did not cite to the *International Multifoods* case at all. While one of the concurrences did mention that case, it was mostly to criticize the "imprecise test" of "delving into extra-statutory sources" such as the "entrails of committee reports, floor statements and Blue Books."

Chief Counsel Advice 201716045.

Stock, which was ranked senior to other classes of stock in both dividend payments and at liquidation, was nonqualified preferred stock under §351(g)(2)(A) because it had no meaningful opportunity to participate in the future growth of the corporation. The CCA found that, while the stock purported to have a participating redemption premium and participating dividend, it really had only "illusory" rights to share in any appreciation in the value of the corporation.

Under §351(a), no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in the corporation and, immediately after the exchange, the person or persons are in control of the corporation within the meaning of §368(c) (i.e., ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of each other class of stock of the corporation). However, §351(b) provides that if other property or money ("boot") is received by a transferor in an otherwise tax-free §351 transaction, the transferor must recognize gain to the extent of the boot received.

When "nonqualified preferred stock" is received by a transferor in exchange for property transferred to a controlled corporation, the nonrecognition rule of §351(a) does not apply. (§351(g)(1)(A)) If the transferor receives stock other than nonqualified preferred stock, §351(b) applies, and the nonqualified preferred stock is treated as "property" (i.e., boot). (§351(g)(1)(B))

"Nonqualified preferred stock" means preferred stock (below) if: (i) the holder of such stock has the right to require the issuer or a related person to redeem or purchase the stock; (ii) the issuer or a related person is required to redeem or purchase such stock; (iii) the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised; or (iv) the dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices. (§351(g)(2)(A))

Observation: According to legislative history, Congress thought that gain should be recognized on the receipt of "nonqualified preferred stock" because it is often a more secure form of investment than other stock, more akin to debt than equity.

Under §351(g)(3)(A), preferred stock is stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent. Stock does not participate in corporate growth unless there's a real and meaningful likelihood that the shareholder will actually participate in the corporation's earnings and growth.

The term "stock" does not include any stock which (A) is not entitled to vote, (B) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (C) has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and (D) is not convertible into another class of stock. (§1504(a)(4))

Taxpayer is a domestic corporation and the common parent of a group of corporations that file a consolidated federal income tax return. Sub 1 is a member of Taxpayer's consolidated group.

Taxpayer had acquired all of the stock of Sub 2 from a third party and, a few years later, contributed it to Sub 1 in a purported §351 transaction in exchange for shares of Sub 1's Class A Stock, Class B stock (voting preferred stock), and Sub 1's note payable (Note). The Note was issued under a credit agreement among Sub 1, Taxpayer (as the initial lender), and Bank (as the administrator).

In Tax Year 1, Taxpayer sold the Note to Bank for face value and sold the Class A stock to Shareholder.

The Class A stock was ranked senior to the Class B stock and the common stock in dividend payments and at liquidation. Quarterly dividends on Class A stock, if declared, were payable based on varying percentages. The stock contained a floating rate dividend that was payable only if preferred dividends or participating dividends were in arrears-and that, for the life of the Class A stock, has not been owed or paid.

The participating dividends with respect to Class A stock were to be paid to a Class A shareholder if dividends were paid on the common stock of Sub 1. During Tax Year 3, Sub 1 made a payment to Shareholder. Sub 1 maintained that the payment was a participating dividend; however, no dividends were paid on the common stock.

At liquidation, dissolution, or winding up of the business, a Class A shareholder was entitled to the stated value of the Class A stock, any dividends in arrears, and a "participating redemption premium" computed at a fixed percentage multiplied by any appreciation in Sub 1's common stock.

Taxpayer treated the Class A stock as permitted property under §351(a) and not as "other property" under §351(b). Taxpayer claimed the Class A stock participates in the growth of Sub 1 to a significant extent and is not preferred stock within the meaning of §351(g)(3)(A) because it had a participating redemption premium and a participating dividend. Taxpayer treated the Class B stock as nonqualified preferred stock within the meaning of §351(g)(2)(A) because it was limited and preferred as to dividends and does not participate in corporate growth to any significant extent.

For Tax Year 1, Taxpayer reported the contribution of Sub 2 to Sub 1 as an exchange under §351(a), treating the Class A stock as preferred stock other than nonqualified preferred stock within the meaning of §351(g)(2)(A), and the Class B stock and Note as "other property" (i.e., boot). Taxpayer calculated the basis of the Note and the Class B stock as equal to their respective estimated fair market values.

Taxpayer reported a long-term capital loss on the sale of the Class A stock to Shareholder. The capital loss offset capital gains in the Tax Year 1 consolidated federal income tax return. Sub 1 reported losses for the 3-year period preceding Tax Year 1 and for the 2-year period following Tax Year 1 (Tax Year 2 and Tax Year 3). Sub 1 made no dividend payments and reported negative retained earnings, for book purposes, for the entire period.

The CCA addressed whether Taxpayer is entitled to a long-term capital loss on the sale of the Class A stock-which depended in part on whether that stock was considered "nonqualified preferred stock" under §351(g)(2)(A).

The CCA determined that the Class A stock was nonqualified preferred stock under §351(g)(2)(A).

Observation: Although the CCA does not expressly reach conclusions beyond the above, this presumably means that, since the Class A stock was ineligible for tax-free treatment under §351, it had a lower basis than Taxpayer originally asserted such that Taxpayer was not entitled to deduct the claimed loss.

The CCA noted that, when making §351(g) determinations, courts have generally looked to the regulations under §305. (See, e.g., *Gerdau Macstell, Inc.,* (2012) 139 TC 67) Regulation §1.305-5(a) provides in part that "preferred stock" generally refers to "stock which, in relation to other classes of stock outstanding, enjoys certain limited rights and privileges...but does not participate in corporate growth to any significant extent." The regulation further clarifies that "a right to participate which lacks substance will not prevent a class of stock from being treated as preferred stock," and provides a number of considerations to take into account in determining when stock has a meaningful probability of actually participating in the earnings and growth of a corporation and whether that participation is significant.

Looking together at the regulations, legislative history, and relevant caselaw, the CCA found that, for preferred stock to be treated as other than nonqualified preferred stock, evidence must exist to show that the preferred stock in question will participate in corporate growth to a significant extent. Merely describing the rights associated with the preferred stock in relation to how the common stock participates is not enough. Applied to the facts of this case, including the lack of dividend payments during the year that Sub 1 had income, the CCA found that the Class A stock did not participate in the growth of Sub 1 to a significant extent, stating that "[a]n illusory right to share in any appreciation" in its value does not evidence the required participation in growth.

Chief Counsel Advice 201714029.

For purposes of computing its domestic production activities deduction (DPAD) under §199, legal fees incurred after that Code Section's effective date, but allocated and apportioned to a prior period under the section 861 method, should not be taken into account in computing the taxpayer's qualified production activities income (QPAI).

Observation: IRS's conclusion here meant that the taxpayer could take a larger DPAD than it would have had IRS come to the opposite conclusion.

Under §199, taxpayers may claim a deduction to offset income from domestic manufacturing and other domestic production activities. In general, the deduction equals 9% of the smaller of the taxpayer's: (a) QPAI for the tax year, or (b) taxable income (modified adjusted gross income, for individual taxpayers), without regard to the §199 deduction, for the tax year. The §199 deduction cannot exceed 50% of the W-2 wages of the employer, attributable to domestic production, for the tax year.

QPAI for any tax year is equal to the excess, if any, of the taxpayer's domestic production gross receipts (DPGR) from specified activities over the sum of the cost of goods sold (CGS) allocable to DPGR and other expenses, losses, or deductions (other than the deduction allowed by §199) that are properly allocable to such receipts.

Regulation §1.199-4(b) provides rules for allocating CGS to DPGR.

Regulation §1.199-4(c) provides rules for allocating other expenses, losses or deductions to DPGR. That regulation requires a taxpayer to use the "section 861 method" of Regulation §1.199-4(d) to allocate and apportion deductions to gross income attributable to DPGR for purposes of determining QPAI, unless the taxpayer qualifies for, and elects to use, one of the two simplified methods available to small taxpayers for allocating and apportioning deductions.

Under the section 861 method, a deduction is allocated to a class of gross income, and then, if necessary, apportioned between the statutory and residual groupings of gross income within that class. (Regulation §1.861-8(a) and Regulation §1.861-8T) The allocation and apportionment of the deduction is based on the factual relationship of the deduction to a class of gross income and to the statutory and residual groupings of income in that class. (Regulation §1.861-8(a)(2)) The statutory grouping of gross income means the gross income from a specific source or activity which must first be determined in order to arrive at taxable income from such specific source or activity under an operative section. (Regulation §1.861-8(a)(4) and Regulation §1.861-8(f))

Regulation §1.861-8(b)(2) provides that a deduction is considered definitely related to a class of gross income, and, therefore allocable to such class, if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. The regulation also provides that if a deduction is definitely related to a class of gross income, the deduction will be allocated to that class even if the amount of the deduction exceeds the gross income in that class for the tax year, including if there is no gross income in that class in the tax year. As with the allocation of a deduction to a class of gross income, the apportionment of a deduction to a statutory grouping of gross income must be made in a manner that reflects the factual relationship between the deduction and the statutory grouping of gross income. (Regulation §1.861-8T(c)(1))

Parent, a holding company, and its U.S. subsidiaries, including Subsidiary, filed a consolidated Federal income tax return for all relevant years. Subsidiary and a disregarded entity within Parent's consolidated group manufactured and sold Products W and X in years preceding and after the enactment of §199, which is effective for tax years beginning after December 31, 2004.

During Years 1 and 4 (which were post-2004 tax years), substantially all of Subsidiary's gross receipts were DPGR from the sale of Products W and X. However, during those years, Parent's consolidated group's gross receipts comprised both DPGR and non-DPGR. Parent determined its QPAI for Years 1 through 4 on a consolidated basis under Regulation §1.199-7(d)(4)(ii).

Litigation legal fees were incurred by Parent, Subsidiary, and other corporations and disregarded entities within Parent's consolidated group to defend lawsuits filed against them alleging harm from the use of Products W and X manufactured and sold by Subsidiary and a disregarded entity in years before the effective date of §199.

Parent deducted these amounts on its consolidated Federal income tax return for Years 1 through 4. None of these legal fees were capitalized under §263A and its regulations. Parent submitted informal refund claims asserting that, under the section 861 method, the deduction for the legal fees in question should not be attributable to DPGR in computing Parent's QPAI.

In the CCA, IRS concluded that the legal fees at issue should not be taken into account in determining Parent's QPAI in Years 1 through 4. As a result, the deductions for the legal fees would not reduce Parent's QPAI and its §199 deduction in the year the legal fees were incurred.

The section 861 method required the determination of the factual relationship of a deduction to a class of gross income and to the statutory and residual groupings of gross income within that class of gross income. The deductions for the legal fees related to the defense of lawsuits filed against Parent, Subsidiary, other corporations, and disregarded entities within Parent's consolidated group alleging harm from the use of Products W and X manufactured and sold by Subsidiary and a disregarded entity in years before §199 's effective date. IRS determined that the facts confirmed that these fees were definitely related to gross income from those product sales.

The fees were incurred as a result of, or incident to, and so are properly allocated to, the class of gross income from the specific sales, all of which occurred in years prior to the effective date of §199, of Products W and X that gave rise to the lawsuits. There was a strong factual relationship between the deductible legal fees at issue and the class of gross income attributable to the specific sales to the plaintiffs in the lawsuits of Products W and X. Because gross receipts from those sales did not generate gross income attributable to DPGR in the years the gross income was realized, no portion of the deductions for the legal fees at issue should be apportioned under the section 861 method to the statutory grouping of §199 gross income in Years 1 through 4. Accordingly, the legal fees at issue should not be taken into account in determining Parent's QPAI in Years 1 through 4.

IRS reasoned that because the W and X product sales were all made before the effective date of §199, those sales did not generate DPGR, and the legal fees incurred to defend against the lawsuits that were properly allocated to the class of gross income attributable to those sales were under the section 861 method factually apportioned exclusively to the residual grouping of income that was not gross income attributable to DPGR.

IRS noted that, in reaching its decision, it considered, but ultimately dismissed as unsupported by the facts in this case, other possible bases on which to allocate and apportion the litigation damages award payments. For example, it considered whether the legal fees should be allocated to all of the gross income of the Parent's affiliated group because they were supportive in nature; whether the legal fees were incurred in connection with an ongoing business of producing and selling Products W and X and so were factually related to gross income attributable to past, present and future sales of Product W and X, in which case a reasonable apportionment between prior sales that did not generate DPGR and prior, present, and future sales that generated or will generate DPGR would be required; and whether the legal fees were incurred to preserve Parent's, Subsidiary's, and other group members' current assets, enhance the value of its brand, and generate future sales and therefore should be apportioned exclusively to gross income attributable to present and future sales of Product W and X that generate DPGR.

Chief Counsel Advice 201653017.

Corporation, whose only assets were partnership interests and whose only income was pass-through income from the partnerships, was a holding or investment company and was liable for the accumulated earnings tax despite the fact that it had no liquid assets and did not control the partnerships.

The accumulated earnings penalty tax is only imposed on a corporation whose earnings and profits (E&P) were accumulated with the purpose of avoiding income tax on its shareholders. (§532(a)) A corporation that accumulates E&P beyond the reasonable needs of its business is considered to have done so to avoid tax on its shareholders unless it proves the contrary by a preponderance of the evidence. (§533(a)) The accumulated earnings tax applies to a corporation's accumulated taxable income (§531). Accumulated taxable income is taxable income with a number of adjustments, one of which is a deduction for dividends paid. (§535(a))

One of the components of the deduction for dividends paid is consent dividends. (§561(a)(1)) §565(a) provides that if any person owns consent stock (meaning common stock or participating preferred stock) in a corporation on the last day of the tax year of such corporation, and such person agrees, in a consent filed with the return of such corporation in accordance with regulations, to treat as a dividend the amount specified in such consent, the amount so specified will constitute a consent dividend. In explaining the effect of consent dividends, §565(c) provides that the amount of the dividend will be considered: (1) as distributed in money by the corporation to the shareholder on the last day of the tax year of the corporation; and (2) as contributed to the capital of the corporation by the shareholder on such day.

Under §533(b), if a corporation is a mere holding or investment company, that fact will be prima facie evidence of the purpose to avoid income tax with respect to the corporation's shareholders. A "holding company" within the meaning of §533(b) is a corporation having practically no activities except holding property and collecting the income therefrom or investing therein. If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property (whether upon an outright or marginal basis), so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation will be considered an investment company within the meaning of §533(b). (Regulation §1.533-1(c))

Taxpayer is a corporation wholly owned by Shareholder. Shareholder transferred to Taxpayer his entire interest in eight partnerships, Partnership 1 through Partnership 8.

Partnership 1 served as the manager for all of the entities that were contributed to Taxpayer. Partnership 1 itself was managed by a board consisting of six members, including Taxpayer. Each member of the board was a "Director" with power to vote on partnership matters. With certain exceptions, any action taken by the board required approval by a majority of the board.

Each of the partnership agreements contained a provision allowing the partnership to make distributions to its partners sufficient to pay the respective partner's federal and state tax liability with respect to partnership income, but the remainder of the respective partner's distributive share of the partnership income was retained in the partnership. Accordingly, Taxpayer reported its share of distributive partnership income but only received distributions sufficient to pay its tax liability.

All of the income and essentially all of the expenses reported by Taxpayer were flow-through items from the various partnerships. The flow-through income consisted of dividends, interest, capital gain, Form 4797 gain, and other income. The other income as reported on Taxpayer's tax returns consisted of Schedule K-1s' ordinary income (line 1) and Schedule K-1s' other income (line 11) (less any interest income, dividend income, capital and ordinary gains that were included in the Schedule K-1s' other income, and netted with any net §988 gains or losses, net swap expense, trade or business interest expense, and other trade or business expenses).

Since its inception and during the years at issue, Taxpayer conducted no business activity other than holding and maintaining the various partnership interests contributed to it by Shareholder. Taxpayer had no employees and paid no wages or expenses, other than a minimal amount for accounting and other fees. Taxpayer neither declared any dividends nor did it otherwise make any distributions to Shareholder. And, Taxpayer reported a receivable from Shareholder for all three years at issue.

IRS determined that Taxpayer was liable for the accumulated earnings tax.

Taxpayer argued that it was not liable for the accumulated earnings tax because it did not have control over distributions from the partnerships in which it invested. Taxpayer claimed that, because its taxable income was derived solely from partnerships from which it could not control distributions, Taxpayer did not have liquid capital from which to distribute earnings to its shareholder and therefore should not be subject to the accumulated earnings tax.

IRS noted several points in refuting this argument.

First, it said that Taxpayer seemed to suggest that accumulated surplus must be represented by cash that is available for distribution. However, IRS said, the Code computes the accumulated earnings tax based on accumulated taxable income, and at least with respect to a mere holding company for which reasonable needs of a business are not relevant, it is not concerned with the liquid assets of the corporation. §535 uses "taxable income" as a starting point for defining "accumulated taxable income," and none of the adjustments to taxable income provided in §535(b) include the undistributed income of partnerships owned by the corporation.

And, IRS said that Taxpayer had no activity other than holding and maintaining the various partnership interests transferred to it by Shareholder. Furthermore, none of the partnerships in which it owned an interest, controlling or otherwise, appeared to perform any activity other than investment activity. Accordingly, Taxpayer was a mere holding or investment company, and there was at least prima facie evidence that Taxpayer was formed to avoid tax, as provided by §533(b) and Regulation §1.533-1(c).

But, IRS's principal argument was that the consent dividend procedures provided by §565 were enacted to address situations where a corporation that accumulated earnings beyond its reasonable needs may lack the ability to pay dividends because of a lack of liquidity or for other reasons.

It cited PLR 9124001, which had similar facts to those here except that in that ruling, the taxpayer's controlling shareholder controlled both the taxpayer and the partnership in question. The ruling rejected the liquidity argument, and its rationale did not depend on the controlling shareholder's control of the partnership that retained all of the earnings.

Because consent dividends could have been used by Taxpayer and Shareholder (i.e., Taxpayer's sole and controlling shareholder) to distribute Taxpayer's E&P, Taxpayer was subject to the accumulated earnings tax in spite of its lack of liquidity and lack of control over the partnerships in which it invested.

Chief Counsel Advice 201650012.

§41(d)(4)(E), dealing with whether research with respect to computer software developed primarily for internal use was qualified research, was not self-executing. Accordingly, except for the limited exceptions specified in the Code that were not applicable to the taxpayer, such computer software was not qualified research for the taxpayer in the absence of final regulations.

The research credit is a credit available to certain persons that conduct "qualified research." (§41(a); §41(b)) One of the requirements for research to be qualified research is that substantially all of the activities of the research constitute elements of a process of experimentation. (§41(d)(1)(C))

§41(d)(4)(E) provides that, except to the extent provided by regulations, research with respect to computer software that is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer is excluded from the definition of qualified research under §41(d). Software that is developed for use in an activity that constitutes qualified research, and software that is developed for use in a production process with respect to which the general credit eligibility requirements are satisfied, are not excluded as internal use software under §41(d)(4)(E).

The legislative history of the Tax Reform Act of 1986, Public Law 99-514 (1986 Act), states that "the costs of developing software are not eligible for the credit where the software is used internally, for example, in general and administrative functions (such as payroll, bookkeeping, or personnel management) or in providing noncomputer services (such as accounting, consulting, or banking services) except to the extent permitted by Treasury regulations." See H.R. Conf. Rep. No. 841, at II-73 (1986 legislative history). The 1986 legislative history further states that Congress intended that regulations would make the costs of new or improved internal use software eligible for the credit only if the research satisfies, in addition to the general requirements for credit eligibility, an additional three-part "high threshold of innovation" test (that is, that the software is innovative, that the software development involves significant economic risk, and that the software is not commercially available for use by the taxpayer).

In January of 2001, IRS issued final regulations under §41(d)(4)(E) (2001 final regulations). Former Regulation §1.41-4(c)(6)(vi) provided that software satisfied the high threshold of innovation test only if the taxpayer could establish that: (a) The software was innovative in that the software was intended to result in a reduction in cost, improvement in speed, or other improvement, that was substantial and economically significant; (b) The software development involved significant economic risk in that the taxpayer committed substantial resources to the development, and there was a substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period; and (c) The software was not commercially available for use by the taxpayer in that the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the requirements of (a) and (b). Former Regulation §1.41-4(c)(6)(vii) provided that, as part of the three-part high threshold of innovation test, there was a requirement to compare the intended result with software that is within the common knowledge of skilled professionals in the relevant field.

In December of 2001, IRS issued proposed regulations (2001 proposed regulations) with respect to the high threshold of innovation test, that clarified the first requirement of the test and provided that computer software developed primarily for internal use was innovative if the software was intended to be unique or novel and was intended to differ in a significant and inventive way from prior software implementations or methods. Under the 2001 proposed regulations, the second and third requirements of the high threshold of innovation test were the same as under the 2001 final regulations. The 2001 proposed regulations also removed explicit references to the common knowledge of skilled professional standard for application of the high threshold of innovation test.

In January of 2004, IRS issued final regulations (2004 final regulations) that finalized the 2001 proposed regulations' rules relating to the definition of qualified research under §41(d) but removed the provisions on computer software developed primarily for internal use and marked former Regulation §1.41-4(c)(6) as "Reserved." The 2004 final regulations applied to tax years ending on or after December 31, 2003.

IRS issued proposed regulations (2004 proposed regulations) concurrently with the 2004 final regulations. Recognizing that while IRS worked on new regulations, taxpayers needed guidance with respect to computer software developed primarily for internal use, the 2004 proposed regulations provided that for tax years beginning after December 31, 1985, and until further guidance was published in the Federal Register, taxpayers could continue to rely upon all provisions of the 2001 proposed regulations, or all provisions of the 2001 final regulations with respect to their research activities related to computer software developed primarily for internal use.

In January of 2015, IRS issued proposed regulations on the application of the research credit to internal use software. The 2015 proposed regulations similarly provided that for tax years ending prior to publication of the 2015 proposed regulations, taxpayers could choose to follow either all of the provisions on computer software developed primarily for internal use under former Regulation §1.41-4(c)(6) in the 2001 final regulations or under the 2001 proposed regulations. However, the 2015 proposed regulations provided that the proposed rules, when finalized, would be prospective only.

In October of 2016, IRS issued final regulations, generally effective when published (October 4, 2015), that provided a definition of internal use software and described software that was not internal use. The final regulations also provided that certain internal use software was eligible for the research credit if the software satisfied the high threshold in the innovation test. The regulations provided rules for computer software that was developed for both internal use and non-internal use (dual function computer software). Examples in the regulations illustrated the application of these rules for internal use software.

Taxpayer claimed research credits under §41 for tax years ending before the issuance of the 2015 proposed regulations. The credit included qualified research expenses related to research with respect to computer software developed primarily for internal use.

Taxpayer took the position that if it chose to apply the provisions for computer software developed primarily for internal use provisions in the 2001 final regulations, the "common knowledge of skilled professionals" standard in former Regulation §1.41-4(c)(6)(vii) of those regulations did not apply. Alternatively, Taxpayer argued that it could apply the 1986 legislative history, which did not reference the "common knowledge of skilled professionals" standard as part of the three-part high threshold of innovation test.

In the CCA, IRS concluded that §41(d)(4)(E) was not self-executing for purposes of determining whether research with respect to computer software developed primarily for internal use was qualified research. In the absence of final regulations, research with respect to computer software developed primarily for internal use was not qualified research (except for the limited exceptions provided in the Code that did not apply to Taxpayer).

IRS found that the delegation of authority from Congress to IRS to provide regulations under §41(d)(4)(E) involves a policy call to be made by IRS concerning whether, and under what circumstances, computer software developed primarily for internal use should be eligible for the credit. Thus, the issuance of regulations is a precondition to the determination of whether such research is qualified research. In addition to the statutory text itself, the legislative history to

§41(d)(4)(E) also supports the view that Congress intended for IRS to issue regulations under §41(d)(4)(E) with respect to the three-part high threshold of innovation test to make the provision operative.

Where the Code grants IRS regulatory authority, courts have frequently determined whether the statutory provision is self-executing or, in other words, whether the statutory provision at issue is operative in the absence of regulations. In making this determination, courts draw a distinction between a "how" statute and a "whether" statute. A statute is self-executing when regulations are not necessary to determine "whether" the statute applies in the first instance, but Congress leaves the mechanics or details affecting the application of the statute to IRS. In such case, the promulgation of regulations only constitutes a means of arriving at "how," not whether the provision applies. (Estate of Neumann, (1996) 106 TC 216)

Conversely, a statute is not self-executing if the statue requires a "whether" Regulation That is, the promulgation of regulations is a necessary condition precedent to determining "whether" the statutory provision applies. (Alexander, (1990) 95 TC 467, aff'd sub nom. *Stell v. Commissioner,* (CA 9 1993) 999 F.2d 544 (unpublished))

In the CCA, IRS determined that as provided in the 2004 proposed regulations, Taxpayer may choose to apply either all of the provisions for computer software developed primarily for internal use in the 2001 final regulations, or all of such provisions in the 2001 proposed regulations for purposes of the three-part high threshold of innovation test with respect to tax years ending before the issuance of the 2015 proposed regulations and for which there were no final regulations in effect.

If Taxpayer chooses to apply the 2001 final regulations, it must apply all of that final regulation for purposes of the three-part high threshold of innovation test, including the common knowledge of skilled professionals standard under former Regulation §1.41-4(c)(6)(vii).

Chief Counsel Advice 201650013.

Parent Corporation was entitled to deduct its loss on the worthlessness of the stock of a subsidiary in the year that the parent elected to change the classification of the subsidiary from a corporation to a disregarded entity. The CCA reasoned that the classification change caused the subsidiary to cease to be a member of the parent's consolidated group, which was an identifiable event that fixed the loss and allowed the parent to deduct it in that year.

A taxpayer may claim as a deduction any loss sustained during the year and not compensated for by insurance or otherwise. (§165(a)) To be allowable as a deduction under §165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, with certain exceptions, actually sustained during the tax year. (Regulation §1.165-1(b), Regulation §1.165-1(d))

If any security which is a capital asset becomes worthless during the tax year, the resulting loss is treated as a loss from the sale or exchange, on the last day of the tax year, of a capital asset. (§165(g)(1)) For purposes of a worthless security deduction, the term "security" includes a share of stock in a corporation. (§165(g)(2)(A))

Any security in a corporation affiliated with a taxpayer that is a domestic corporation is not treated as a capital asset by that taxpayer. (§165(g)(3)) A corporation is treated as affiliated with the taxpayer only if: (i) the taxpayer directly owns stock of the corporation that meets the requirements of §1504(a)(2), and (ii) more than 90% of the corporation's gross receipts for all tax years are from sources other than royalties, certain rents, dividends, certain interest, annuities, and gains from sales of stocks and securities.

Whether a loss due to worthlessness actually is sustained during the tax year is a factual determination. (*Boehm v. Commissioner,* (Sup Ct 1945) 34 AFTR 10) A taxpayer must prove with objective evidence that the stock in question became worthless during the tax year. (Id.)

Stock becomes worthless in the tax year in which it has some value at the beginning of the year and has no value at the end of the year. In *Morton,* 38 BTA 1270, aff'd (CA 7 1940) 25 AFTR 76, the Court denied a taxpayer's worthless stock deduction because it had become useless in a prior year.

In the event of a corporate liquidation, the stock of the corporation is worthless if the shareholders do not receive payment for their stock. (*H.K. Porter Co.,* (1986) 87 TC 689) Additionally, the liquidation is an identifiable event that fixes the loss with respect to the stock.

In Revenue Ruling 2003-125, 2003-2 CB 1243, an eligible entity treated as a corporation for U.S. federal income tax purposes elected to change its classification from a corporation to a disregarded entity, and IRS determined that the shareholders were allowed a worthless security deduction under §165(g) if the fair market value of the assets of the entity, including intangibles, did not exceed the entity's liabilities such that on the deemed liquidation of the entity, the shareholders received no payment on its stock.

Under Regulation §1.1502-80(c)(1), subsidiary stock is not treated as worthless under §165 until immediately before the earlier of the time (i) the stock is worthless within the meaning of Regulation §1.1502-19(c)(1)(iii), or (ii) the subsidiary for any reason ceases to be a member of the group. Regulation §1.1502-19(c)(1)(iii) provides three different identifiable events, the occurrence of which can be used to prove worthlessness:

1. Substantially all of the subsidiary's assets are treated as disposed of, abandoned, or destroyed for Federal income tax purposes, or, if the subsidiary's asset is stock of a lower-tier member, the stock is treated of as disposed of under Regulation §1.1502-19(c).

2. The indebtedness of a subsidiary is discharged, if any part of the amount discharged is excluded from gross income and is not treated as tax-exempt income under Regulation §1.1502-32(b)(3)(ii)(C) (i.e., applied to reduce tax attributes).

3. A group member takes into account a deduction or loss on account of the uncollectability of a subsidiary's indebtedness, and the deduction or loss is not matched in the same tax year by the subsidiary's taking into account a corresponding amount of income or gain from the debt in determining consolidated taxable income.

Taxpayer is the common parent of a consolidated group of corporations that join in the filing of a consolidated federal income tax return. Taxpayer is wholly owned, directly and indirectly, by Foreign Parent, which historically was part of the Historic Parent group and was separated from the Historic Parent group as part of a restructuring in Year 2.

Foreign Parent directly and indirectly owns all of the stock of FSub. Prior to Date 4, Year 4, Taxpayer owned all of the stock of Sub, but on that date Taxpayer sold a percentage of the common stock of Sub to FSub for nominal consideration. On Date 2, Year 6, FSub sold the interest in Sub back to Taxpayer for nominal consideration.

Prior to its acquisition, Sub was publicly traded. Historic Parent purchased Sub from its public shareholders on Date 1, Year 1. As part of the acquisition transaction, Sub became liable on intercompany loans that were used to finance the acquisition transaction. After various assignments of debt, most of Sub's intercompany debt was owed to FSub.

Between Years 2 and 3, Sub sold various non-core assets to third parties and used a portion of the proceeds to repay intercompany debt. After the various restructurings of Sub's operations and the repayment of debt, as of the end of Year 3, Sub still had outstanding debt to FSub and also owed a very small amount to Taxpayer.

According to documentation provided by Taxpayer, Taxpayer determined that the value of Sub's assets had declined by the end of Year 3 and that, because of this decline and the sales of operating assets to pay intercompany debt, Sub had a negative net worth. Additional documentation provided by Taxpayer indicated that Taxpayer determined that Sub had a negative net worth at the end of both Years 4 and 5.

Because of Sub's reduced scope of operations, among other reasons, Foreign Parent determined that part of the remaining debt Sub owed to FSub should be forgiven. Thus, on Date 5, Year 4, FSub forgave a portion of the Sub debt and forgave an additional amount one year later. Taxpayer treated the cancellation of debt as a contribution to the capital of Sub under §108(e)(6).

On Date 3, Year 6, Taxpayer filed a Form 8832 to elect to treat Sub as an entity disregarded as separate from the Taxpayer. On its federal income tax return for Year 6, Taxpayer claimed a loss on the stock of Sub under §165(g)(3) and Revenue Ruling 2003-125.

The CCA found that, assuming the Sub stock was worthless for §165 purposes as of the end of Year 3 and at all times during the years at issue, the deduction of Taxpayer's loss on its worthlessness was deferred until one of four identifiable events occurs: the three events listed in Regulation §1.1502-19(c)(1)(iii), or Sub's ceasing to be a member of Taxpayer's group for any reason.

In this case, none of the identifiable events in Regulation §1.1502-19(c)(1)(iii) (described above) applied. While Sub disposed of subsidiaries and non-core lines of business, substantially all of its assets were not treated as disposed of, abandoned or destroyed for federal income tax purposes. And, no member of Taxpayer's group has taken a deduction or loss on the uncollectability of the debt of Sub; and F Sub's contribution of the Sub indebtedness to capital under §108(e)(6) did not produce cancellation of indebtedness income.

However, the CCA concluded that the change in Sub's classification in Year 6, from a corporation to an entity disregarded as separate from Taxpayer, caused Sub to cease to be a member of the Taxpayer's consolidated group. Accordingly, based on Regulation §1.1502-80(c)(1)(ii) and Revenue Ruling 2003-125 Taxpayer could recognize its loss on the Sub stock in Year 6.

Chief Counsel Advice 201642035.

Two scenarios are analyzed in which a taxpayer received a termination fee from a party that backed out of a stock acquisition deal. It concluded that gain or loss is to be determined by reducing the fee by any costs incurred by the taxpayer in the process of investigating and pursuing the transaction, that were properly capitalized under Regulation §1.263(a)-5(e). IRS also found that §1234A applied, so the gain or loss was a capital gain or loss.

Observation: In the CCA, IRS noted that it reached a contrary conclusion to the one it reached on similar facts in PLR 200823012, which held without explanation that the receipt of a termination fee like that in Situation 1 resulted in ordinary income.

§1222 provides that capital gain or loss is gain or loss from the exchange of a "capital asset," which §1221(a) generally defines as any property held by the taxpayer (whether or not connected with his trade or business), subject to certain exclusions not applicable here.

Under §1234A, gains or losses are capital gains or losses if they are attributable to a cancellation, lapse, expiration, or other termination of a right or obligation (other than a securities futures contract) as to property if the property is (or would be, if acquired) a capital asset in the hands of the taxpayer. Stock is generally considered a capital asset. (*Appalachian Electric Power Co v. U.S.,* (1958, Ct Cl) 1 AFTR 2d 628)

§165(a) allows a deduction for any "uncompensated loss" sustained during the tax year. §165(f), however, provides that capital losses are subject to the limitations in §1211 and §1212. Under §1211, in the case of a corporation, capital losses from sales or exchanges of capital assets are allowed only to the extent of capital gains from sales or exchanges of capital assets, and §1212 provides for the carryover of excess capital losses.

Domestic Corporation Acquirer entered into a bilateral agreement (Contract) with another corporation, Target, under which the parties agreed to undertake a series of steps that would result in Acquirer's acquisition of Target's stock. At the time that the Contract was entered into, Target's stock was publicly traded on an established exchange.

The Contract required both Acquirer and Target to pursue a plan of merger by making best efforts to effectuate Acquirer's proposed stock acquisition through a merger of a newly formed, wholly owned subsidiary of Acquirer with and into Target, including by recommending the deal to their respective shareholders and obtaining required governmental approvals. Under the Contract, Target was required to recommend to its shareholders that they approve the plan of merger, subject to the receipt of a superior offer. The Contract provided that Target could terminate the contract upon (i) entering into another agreement based on a superior offer, (ii) a rejection of Acquirer's offer by Target's shareholders, or (iii) a failure to obtain approval of Target's shareholders by a certain date; in the event the Contract was terminated due to one of these reasons, Target had to pay a termination fee of $1,000,000 to Acquirer.

Target received a superior offer from an unrelated company and entered into another agreement with that company. As a result, Target terminated the Contract and paid Acquirer the $1,000,000 termination fee.

In Situation 1, in addition to the above facts, at the time the Contract was terminated, Acquirer had incurred $200,000 of costs in the process of investigating and pursuing the transaction, that Acquirer properly capitalized as costs of facilitating the proposed transaction under Regulation §1.263(a)-5(e).

In Situation 2, in addition to above facts (and unlike the gain scenario in Situation 1), at the time the Contract was terminated, Acquirer had incurred costs in the amount of $1,100,000 that Acquirer properly capitalized as costs of facilitating the proposed transaction under Regulation §1.263(a)-5(e).

In the two Situations, IRS found that gain or loss was determined by reducing any fee received for the termination of the agreement by any costs incurred in the process of investigating and pursuing the transaction that were properly capitalized under Regulation §1.263(a)-5(e). IRS also noted that the label "termination fee" was not determinative, and the specific provisions of the contract in question in a given case must be examined to determine the correct tax treatment. In both Situations 1 and 2, IRS determined that §1234A applied to the gain or loss realized by the taxpayer.

In both Situations 1 and 2, under §1221, Target's stock would be a capital asset in Acquirer's hands upon acquisition. The Contract provides Acquirer with a bundle of rights vis-à-vis Target that relates to Acquirer's proposed acquisition of Target stock. Although the Contract was between Acquirer and Target rather than between Acquirer and Target's shareholders, a contract between the acquiring corporation and the target corporation is a customary part of the process by which the stock of a publicly held corporation is acquired. The Contract imposed obligations on both parties with respect to Target's stock. The Contract also provided Acquirer with rights with respect to Target's stock.

IRS found that the termination fee payable to Acquirer under the Contract was in the nature of liquidated damages rather than as compensation for services. Consistent with the purpose of §1234A, any gain or loss realized by Acquirer on the termination of the Contract-which provides rights and obligations with respect to Target's stock, a capital asset-would be capital in nature.

In Situation 1, IRS found that Acquirer's amount realized from the receipt of the termination fee ($1,000,000) was reduced by Acquirer's capitalized facilitative costs ($200,000). Because this gain was attributable to the termination of Acquirer's right with respect to Target's stock-property that would have been a capital asset in Acquirer's hands-the gain was treated as a gain from the sale of a capital asset under §1234A. Accordingly, IRS determined that Acquirer had a capital gain of $800,000 (the $1,000,000 termination fee less Acquirer's capitalized facilitative costs of $200,000).

In Situation 2, IRS found that Acquirer's amount realized from the receipt of the termination fee ($1,000,000) was reduced by Acquirer's capitalized facilitative costs ($1,100,000), resulting in a loss of $100,000. Because this loss was attributable to the termination of Acquirer's right with respect to Target's stock-property that would have been a capital asset in Acquirer's hands-the loss was treated as a loss from the sale of a capital asset under §1234A. Accordingly, IRS determined that Acquirer had a capital loss of $100,000 (the termination fee income of $1,000,000 less Acquirer's capitalized facilitative costs of $1,100,000) that Acquirer could deduct under §165, subject to the limitations on capital losses in §1211 and §1212.

PLR 201734004.

A transfer of certain employees from an existing Blue Cross or Blue Shield (BC/BS) organization does not prevent the proposed transaction, which was designed to separate two of the BC/BS organization's lines of business, from qualifying for favorable tax treatment under §355. The PLR also concluded that, since the BC/BS organization's sole shareholder is itself tax-exempt, the distribution described in the PLR does not present evidence of a device to impermissibly distribute earnings and profits (E&P) under Regulation §1.355-2(d).

Under §355(a), if certain requirements are satisfied, a distributing corporation may distribute the stock (or stock and securities) of a controlled corporation to its shareholders and security holders without the distributing corporation, its shareholders, or its security holders recognizing income, gain, or loss on the distribution. A "controlled corporation" is defined by reference to §368(c), which defines control as ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.

One such requirement is the "active trade or business requirement" of §355(b), which requires that:

a. Each corporation is engaged, immediately after the distribution, in the active conduct of a trade or business;

b. Each trade or business was actively conducted throughout the 5-year period ending on the date of the distribution; and

c. Neither trade or business was acquired in a transaction in which gain or loss was recognized, in whole or in part, within the 5-year period.

In addition, the transaction must not be used principally as a device for distributing earnings and profits of either the distributing or controlled corporation. (§355(a)(1)(B)) Regulations under §355 identify several factors that support or weigh against the conclusion that a transaction is used as a "device." (Regulation §1.355-2(d))

An existing BC/BS organization under §833(c)(2) is an organization that was in existence on August 16, 1986, that was determined to be exempt from tax for its last tax year beginning before January 1, 1987, and that has had no material change in its operations or structure after August 16, 1986 and before the close of the tax year. Existing BC/BS organizations are favorably taxed as though they were stock insurance companies. (§833(a)(1))

Parent is an entity exempt from federal income tax under §501(c)(3) that is the parent entity to a group of corporations (collectively, Parent Group). Parent owns all of the stock in Acquiring, a corporation, as well as the sole membership interest in Distributing, a non-stock corporation engaged in Business A and Business B that is an existing BC/BS organization under §833(c)(2).

In Month 1, Year 1, Distributing transferred some of its management and operational employees of Business B to Acquiring (the Employee Transfer). Prior to the Employee Transfer, Business B was operated entirely by Distributing and had been providing Business B services to members of the Parent Group and to third-party customers.

The proposed transaction consists of the following steps:

a. The Contribution. Distributing will form a new, wholly-owned corporation (Controlled) and contribute all of the assets (including Product) and the remaining employees of Business B to it.

b. The Distribution. Distributing will distribute all the stock of Controlled to Parent.

c. The Merger. Controlled will merge with and into Acquiring, with Acquiring surviving.

After the proposed transaction, Distributing will own the Business A assets, and Acquiring will own the Business B assets (including Product). For purposes of satisfying the active trade or business requirement of §355(b), Distributing intends to rely on Business A, and Controlled intends to rely on Business B.

Parent has represented that, with respect to the proposed transaction, it has no plan or intention to cease to be tax-exempt under §501(c)(3), or to sell or otherwise dispose of any portion of the stock of Distributing, Controlled, or Acquiring. The parties also represented that if §355 did not apply to the Distribution, the receipt of the stock of Controlled would not be taxable to Parent.

The PLR concluded that:

1. The membership interest Parent holds in Distributing will be treated as stock for purposes of §355(a)(1)(A).

2. The Employee Transfer will not prevent Controlled from satisfying the active trade or business requirement of §355(b) with respect to the Distribution.

3. Because Parent is tax-exempt under §501(c)(3), and because Parent is the sole shareholder of Distributing, the Distribution does not present evidence of device. (Regulation §1.355-2(d))

The PLR specified that no opinion was requested or expressed as to whether the proposed transaction involves a "material change" to Distributing's operation or structure under §833(c)(2).

PLR 201731015.

Software user group whose membership is limited to organizations licensed to use the software of a particular software company did not qualify as a tax-exempt business league.

§501(c)(6) provides for exemption of business leagues, chambers of commerce, real estate boards, boards of trade, etc., which are not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Regulation §1.501(c)(6)-1 states that a business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus, its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. An organization, whose purpose is to engage in a regular business of a kind ordinarily carried on for profit, even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league.

In Revenue Ruling 74-147, 1974-1 CB 136, the taxpayer was an organization whose members represented diversified businesses that own, rent, or lease computers produced by various manufacturers. It was organized to improve the efficiency of its members' use of computers; it qualified for exemption under §501(c)(6). The common business interest of the members of the organization was their common business problems concerning the use of computers. The primary objective of the organization was to provide a forum for the exchange of information which would lead to the more efficient utilization of computers by its members and other interested users, and thus improve the overall efficiency of the business operations of each.

In Revenue Ruling 83-164, 1983-2 CB 95, the taxpayer was an organization whose members represented diversified businesses that own, rent, or lease computers produced by a single computer manufacturer. It did not qualify for exemption under §501(c)(6). This organization did not improve conditions in the lines of business from which its members were drawn, but only in the segments of those lines of business which utilized the computers of a single manufacturer. By limiting its activities to these users, the organization helped to provide a competitive advantage to the manufacturer and to its customers at the expense of their competitors that may use other brands of computers. Thus, the organization's activities were not directed towards the improvement of business conditions in one or more lines of business within the meaning of Regulation §1.501(c)(6)-1.

The taxpayer is a software user group. Membership is available to any organization licensed to use any version of the commercially available D, a product of software company O. The taxpayer will provide a forum for peer to peer interaction for managers, estimators, and sales, production and accounting personnel in the E industry. It intends to produce webinars and short videos highlighting areas of interest to the group. A newsletter highlights upcoming webinars and encourages members to interact on the organization's forum.

Discussions are primarily about issues related to D, but they may also involve other related software produced by O, as well as issues involving mailing software, shipping software, etc.

The taxpayer did not qualify for tax-exempt status as a business league, etc. because it was not organized to improve business conditions of one or more lines of business as defined under §501(c)(6). It is not described in Regulation §1.501(c)(6)-1 because its activities are not directed to the improvement of business conditions of one or more lines of business and it is formed to provide particular services to its members.

It is similar to the organization described in Revenue Ruling 83-164. Its membership is restricted to licensed users of a specific software program. Because it limits its activities to users of D, it helps to provide a competitive advantage to O and its customers at the expense of O's competitors and their customers that may use other brands of software. It does not improve conditions in the lines of business from which its members are drawn, but only in the segments of those lines of business which utilize D.

PLR 201731003.

Taxpayer's divisive reorganization under §355, finding that: (a) the acquisition of another company would be an expansion of its existing business; and (b) the retention of the controlled corporation's stock by members of the taxpayer's group would not be in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax.

Under §355(a), a corporation may distribute stock and securities in a controlled corporation to its shareholders and security holders in a transaction that will not cause the distributees to recognize gain or loss, provided that, among other requirements:

a. Each corporation is engaged, immediately after the distribution, in the active conduct of a trade or business;

b. Each trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution; and

c. Neither trade or business was acquired in a transaction in which gain or loss was recognized, in whole or in part, within the 5-year period. (§355(b))

In determining whether an active trade or business has been conducted by a corporation throughout the 5-year period preceding the distribution, the fact that a trade or business underwent change during that period (for example, by adding or dropping products, making changes in production capacity, and the like) is disregarded, if the changes are not of such a character so as to constitute the acquisition of a new or different business. If a corporation engaged in the active conduct of one trade or business during a 5-year period buys, creates, or otherwise acquires another trade or business in the same line of business, the acquired business ordinarily will be treated as an expansion of the original business, all of which is treated as having been actively conducted during that 5-year period, unless that purchase, creation, or other acquisition effects a change of such a character as to constitute the acquisition of a new or different business. (Regulation §1.355-3(b)(3)(ii))

Ordinarily, the distributing corporation must distribute all of the stock and securities of the controlled corporation that it held immediately before the distribution. (Regulation §1.355-2(e)(1)) However, if the distributing corporation distributes at least an amount of the stock of the controlled corporation that constitutes control, the distribution will still qualify if IRS is satisfied that the retention of stock and/or securities in the controlled corporation is not pursuant to a plan having as one of its principal purposes the avoidance of federal income tax. If the distribution of all stocks and securities would be treated in part as a distribution of "boot" (for instance, distribution of securities without surrender of securities), this fact tends to show that the retention of stock or securities is part of a tax avoidance plan. (Regulation §1.355-2(e)(2))

Taxpayer is the common parent of a business group that includes corporations, disregarded entities, and partnerships (collectively, the Taxpayer Group). Members of the Taxpayer Group have engaged in multiple businesses for at least five years, including Business 1 and Business 2. On Date, a member of the Taxpayer Group acquired OtherCo, which engaged in Business 3.

Taxpayer intends to engage in a number of restructuring transactions. These transactions will include two divisive reorganizations intended to qualify under §368(a)(1)(D) and §355 (the Proposed Divisive Reorganization Transactions).

In one of the Proposed Divisive Reorganization Transactions, in exchange for stock of a newly formed State corporation (Controlled), (a) Taxpayer will contribute to Controlled all of its membership interests in a disregarded entity; and, (b) two members of the Taxpayer Group (Member 1 and Member 2) will contribute an amount of cash to Controlled (the Contribution). After the Contribution, Taxpayer directly will own Controlled stock representing at least 80% of the vote and 80% of the value of all outstanding Controlled shares, and Member 1 and Member 2 will directly own the remainder.

Thereafter, Taxpayer will distribute all of its Controlled stock (the Controlled Distribution). It is expected that, for a period of time after the Controlled Distribution, one director and certain officers of Taxpayer will serve in similar capacities at Controlled (the Overlap), and that the Overlap will benefit Controlled's underlying businesses due to the skills and experience the overlapping management team have gained over the years managing those businesses.

For various reasons explained and supported by an opinion of Investment Bank (the Retention Purposes), Member 1 and Member 2 will retain their Controlled shares (the Controlled Retained Shares and the Controlled Equity Retention). Member 1 and Member 2 will dispose of the Controlled Retained Shares as soon as a disposition is warranted consistent with the Retention Purposes, but in no event later than five years after the Controlled Distribution. During that time, the Controlled Retained Shares will be voted in proportion to the votes cast by the other shareholders of Controlled. With the exception of the Overlap, no one will serve as a director or officer of any combination of Taxpayer, Member 1, Member 2, and Controlled as long as any member of the Taxpayer Group holds the Controlled Retained Shares.

Among other representations, Taxpayer represented that in no event will the Controlled Equity Retention prevent Taxpayer from distributing in the Controlled Distribution an amount of Controlled stock that represents control under §368(c), and that the Controlled Equity Retention will not be in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax.

In the PLR, IRS ruled that, based solely on the information submitted and the representations made:

1. The acquisition of OtherCo on Date will constitute an expansion of Businesses 1 and 2 (under Regulation §1.355-3(b)(3)(ii)) and not the acquisition of a new or different business; and

2. The Controlled Equity Retention will not be in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax under §355(a)(1)(B) and Regulation §1.355-2(e).

PLR 201729020.

Neither of two investors in a partnership that owned and operated refined coal facilities could claim refined coal tax credits from the transaction. The investors had neither any significant opportunity for profit nor risk of loss, and IRS concluded that they entered the transaction solely to obtain tax benefits.

Under §45(e)(8), a producer of refined coal is eligible for a tax credit for qualified refined coal (i.e., which meets certain emission reduction standards) that the taxpayer (i) produces at a refined coal production facility during a 10-year period beginning on the date the facility is placed in service, and (ii) sells to an unrelated person during that 10-year period.

In general, barring express statutory authorization, taxpayers may not sell federal tax benefits. For instance, in Historic Boardwalk Hall, *LLC v. Commissioner,* (CA 3 2012) 110 AFTR 2d 2012-6433, cert denied 5/28/2013, the Third Circuit held that a corporate investor was not a bona fide partner in an LLC and thus could not claim its share of historic rehabilitation tax credits. The Court found that the investor had no "meaningful stake" in the LLC's failure or success and that the transaction was, in substance, a prohibited sale of tax credits.

Taxpayer is a limited liability company (LLC) classified as a partnership for Federal tax purposes that owns and operates two refined coal facilities (Facilities). Taxpayer had three owners during the years at issue: Operator, a C corporation; Investor 1, an LLC classified as a partnership; and Investor 2, a C corporation. Investor 1 is owned in part by Operator and in part by X, an LLC classified as an association for Federal tax purposes.

Prior to the years at issue, Operator formed Taxpayer and was its sole owner during the construction of two refined coal facilities, which were built on a site that Operator, through Taxpayer, leased from Electric Company. The lease was coterminous with the availability of the §45 refined coal tax credit. Operator also licensed a proprietary coal-refining process (Technology) from Licensor, a partnership in which Operator was part owner and managing member, in a license that similarly expired upon termination of §45 credits.

After constructing the facilities, Operator contributed them to Taxpayer, in part directly in exchange for an interest therein, and in part indirectly through Investor 1, which was at that time Operator's wholly-owned and disregarded entity. Operator then caused Taxpayer to enter into agreements, all of which terminated when the availability of the §45 credit ceased, to (i) sub-license Technology; (ii) purchase feedstock coal from Electric Company; and (iii) sell refined coal back to Electric Company at a rate that takes into account the feedstock coal purchase price.

At a later date, X and Investor 2 purchased interests in Investor 1 and Taxpayer, respectively, from Operator. The membership interest purchase prices were approximately equal to a proportionate share of Operator's total capital costs of constructing and installing the Facilities, and thus were described in the TAM as effectively being reimbursements. Each member was obligated to contribute its pro rata share of Taxpayer's ongoing operating expenses, and all items of Taxpayer's income, gain, loss, deduction, and credit (including the §45 credit) were allocated pro rata among its members. The member interest purchase agreements also had a number of provisions, the effect of which was to limit X's and Investor 2's opportunity for profit but also largely eliminate their risk of loss.

Although Taxpayer's operations did not achieve expectations, with Facilities idled for significant periods of time until operations were permanently halted, Investor 1 and Investor 2 nonetheless enjoyed substantial tax benefits (i.e., credits, losses, depreciation) that well exceeded their capital contributions. X and Investor 2 exited the transaction, selling their interests back to Operator, in the year that operations ceased.

At issue in the TAM was whether X and Investor 2 are entitled to claim refined coal tax credits.

IRS concluded that, while "monetization of tax benefits is not necessarily prohibited in the context of a transaction that involves more than a sale of tax benefits," the transaction at issue reflected a mere sale of refined coal tax credits and other tax benefits without anything further. There was no plan on the part of X and Investor 2 to become producers of refined coal through an investment in Taxpayer. Accordingly, they were not entitled to claim refined coal tax credits.

In reaching its conclusion, IRS noted that the transaction provided significant pre-tax profits to both Operator and Electric Company but made it "highly unlikely" that either X or Investor 2 would receive any such benefit in the event that the activity proved to be a success. And, while the transaction guaranteed that X and Investor 2 would suffer "small and carefully circumscribed losses," it effectively insulated them from the risks of failure associated with the activity. IRS further said that those losses "were primarily dependent on the amount of tax credits produced rather than the economic consequences of an investment in a refined coal production activity." Overall, the TAM found that the transaction constituted a prohibited purchase of tax benefits.

IRS rejected Taxpayer's argument that Operator, X, and Investor 2 had "unlimited upside potential" at the time the partnership was formed. The TAM concluded that there were only limited ways that Taxpayer could have reduced its operating costs, that no effort had been made to do so, and Taxpayer's own pre-transaction financial models showed that it expected certain costs to increase. IRS also rejected Taxpayer's claim that it could enter into a new and more favorable contract after the Sub-License, land lease, and §45 credit period expired, noting that at that point, "Taxpayer would own nothing more than a 10-year-old facility with no rights to use the Technology to refine coal and no right to keep the facility on Electric Company's property"; and, while proceeds from any sale of the facility would be shared pro rata, such would be "unlikely to amount to a sum that is significant relative to the parties' investment."

The TAM noted that its conclusion "may seem at odds with the fact that the activity that Congress intended to incentivize did take place, as refined coal was produced." However, it stated that X and Investor 2 did not participate in the production and sale of refined coal but rather just entered the transaction to purchase tax benefits. Citing Historic Boardwalk, the TAM stated that when a partnership's contracts governing a tax credit-generating activity lie on the wrong side of "a defensible distribution of risk and reward," the substance of the transaction points to a "prohibited sale of tax credits."

PLR 201726015.

Permission granted to a taxpayer, pursuant to Regulation §1.1502-75(b)(3), to amend its consolidated return to include its subsidiary as a member as if the subsidiary had timely filed Form 1122 (Authorization and Consent of Subsidiary Corporation to Be Included in a Consolidated Return) and joined in the making of a consolidated return.

An affiliated group of corporations that did not file a consolidated return for the immediately preceding tax year may file a consolidated return in lieu of separate returns for the tax year, provided that each corporation which has been a member during any part of the tax year for which the consolidated return is to be filed consents, in the manner provided in Regulation §1.1502-75(b), to the regulations under §1502. (Regulation §1.1502-75(a)(1))

The consent of a corporation to file a consolidated return is made by the corporation joining in the making of the consolidated return for the year. A subsidiary is also deemed to have joined in the making of a consolidated return for the year if it files a Form 1122 in the manner specified in Regulation §1.1502-75(h)(2). (Regulation §1.1502-75(b)(1)) Under Regulation §1.1502-75(h)(2), for a group to file a consolidated return, a Form 1122 must be executed by each subsidiary. Form 1122 is not required for a tax year if a consolidated return was filed (or was required to be filed) by the group for the immediately preceding year.

If a member of the group fails to file Form 1122, IRS may under the facts and circumstances determine that such member has joined in the making of a consolidated return by such group. Factors IRS will take into account in making this determination include:

a. Whether the income and deductions of the member were included in the consolidated return for such tax year;

b. Whether a separate return was filed by the member for that tax year; and

c. Whether the member was included in the affiliations schedule, Form 851 (Affiliations Schedule), for such tax year. (Regulation §1.1502-75(b)(2))

Regulation §1.1502-75(b)(3) provides that if any member has failed to join in the making of a consolidated return under either Regulation §1.1502-75(b)(1) or Regulation §1.1502-75(b)(2), then the tax liability of each member of the group will be determined on the basis of separate returns unless the common parent corporation establishes to IRS's satisfaction that the failure of the member to join in the making of the consolidated return was due to a mistake of law or fact, or to inadvertence. If the common parent establishes that the failure is due to one these causes, then the member is treated as if it filed Form 1122 for the year. If not, the tax liability of each member of the group must be determined on the basis of separate returns.

If an affiliated group satisfies the conditions described in Revenue Procedure 2014-24, 2014-13 IRB 879, a subsidiary that actually failed to file a Form 1122 (non-filing subsidiary) will be treated as if it had filed a Form 1122 (in an "automatic determination"), and thus joined in the making of a consolidated return by the affiliated group. Revenue Procedure 2014-24 is the exclusive means for IRS to make an automatic determination. If the requirements of Revenue Procedure 2014-24 are not satisfied, an automatic determination is unavailable. However, a subsidiary may request a determination letter under the regulations. IRS may determine on its own accord, or based on the request of a common parent of the affiliated group, that a subsidiary is treated as if it filed Form 1122 in the manner prescribed by Regulation §1.1502-75(h)(2)

On Date 4, Parent (Taxpayer) purchased 100% of the outstanding stock of Sub 1. On Date 3, Parent organized a wholly owned subsidiary, Sub 2, as a limited liability company (LLC) and timely filed Form 8832 (Entity Classification Election) in which Sub 2 elected to be taxed as a corporation for U.S. federal income tax purposes, effective as of its formation.

For the tax year ended Date 2, Parent and Sub 1 filed separate returns. For the tax year ended Date 2, Parent and one of its subsidiaries, Sub 2, elected to file a consolidated return. The Sub 1 separate Form 1120 for the year ended Date 2 reported no income and no deductions.

The Date 2 consolidated return for Taxpayer included Form 1122 Authorization and Consent of Subsidiary Corporation To Be Included in a Consolidated Income Tax Return for Sub 2. The Date 2 consolidated return for Taxpayer included Form 851, on which Sub 2 was the only reported affiliated group member.

IRS concluded that Regulation §1.1502-75(b)(3) applied in this case and that an amended return to include Sub 1 as a member of the Parent consolidated return should be allowed. The taxpayers should be permitted to amend their consolidated return for the tax year ended Date 2 in order to include Sub 1 as a member of the consolidated return as if Sub 1 had timely filed Form 1122, and so joined in the making of a consolidated return.

IRS determined that the Parent affiliated group did not satisfy Revenue Procedure 2014-24 's requirements necessary to obtain automatic relief to treat Sub 1 as if it filed Form 1122 for the tax year ended Date 2. In such a case, IRS could treat Sub 1 as if it had filed a Form 1122 and joined in the filing of the Parent consolidated return under Regulation §1.1502-75(b)(2) or Regulation §1.1502-75(b)(3). But Regulation §1.1502-75(b)(2) did not apply here because: (1) the income and deductions of Sub I were not included in the Parent consolidated return; (2) Sub 1 filed a separate return for Date

2; and (3) Sub 1 was not included in the Parent Form 851 affiliations schedule. In order to obtain relief under Regulation §1.1502-75(b)(3), Sub l's failure to join in the making of the consolidated return must have been due to a mistake of law or fact, or to inadvertence.

IRS found that the fact that the Date 2 consolidated return for Taxpayer included Form 1122 for Sub 2 and included Parent and Sub 2 in the Form 851 Affiliations Schedule indicated that the Parent affiliated group intended to file a consolidated return for the year ended Date 2. IRS reasoned that Regulation §1.1502-75(a)(1) allows the Parent affiliated group to file a consolidated return in lieu of separate returns for the Date 2 tax year, provided that each corporation which was a member of the Parent affiliated group at any time during Date 2 tax year joins in the filing of the Parent consolidated return. Taxpayer stated that at the time of the preparation of the relevant Date 2 U.S. federal income tax returns, Accounting Firm 1 (the return preparer) mistakenly believed that the inclusion of Sub 1 in the consolidated return was voluntary, not mandatory.

IRS concluded that the common Parent Corporation had satisfactorily established that the failure of Sub I to join in the making of the consolidated return was due to a mistake of law. If Parent intended to exercise its privilege of filing a consolidated return, and Parent directly owned at least 80% of the total voting power and 80% of the total value of Sub 1, then Sub 1 was required to join in the filing of the consolidated return in order to obtain the benefits of consolidation and should be treated as if it filed Form 1122 for the Date 2 tax year under Regulation §1.1502-75(b)(3).

PLR 201725022.

Corporation's rental income from owning and operating a medical office complex will not be treated as passive investment income for S corporation purposes.

Under §1362(d)(3)(A)(i), an election under §1362(a) to be treated as an S corporation is terminated whenever the corporation (1) has accumulated earnings and profits at the close of each of three consecutive tax years, and (2) has gross receipts for each of these tax years more than 25% of which are passive investment income. Rents generally are included in the definition of passive investment income. (§1362(d)(3)(C)(i))

Under Regulation §1.1362-2(c)(5)(ii)(B)(1), "rents" means amounts received for the use of, or the right to use, property (whether real or personal) of the corporation. However, under Regulation §1.1362-2(c)(5)(ii)(B)(2), "rents" does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in the active trade or business of renting property only if, based on all of the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business.

Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based on all of the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

X Corp had been taxed as a C corporation since its formation but intends to elect to be an S corporation effective for Year 2. X is active in the business of acquiring, developing, leasing and managing commercial real estate, concentrating in medical office suites and clinics. Its primary asset is the M development, composed of a parcel of land situated on two contiguous lots. When it was bought, M was partially developed as a plaza containing single-story buildings in a cottage complex along with a single two-story building. X later constructed another building to the cottage complex and a separate two-story building. Subsequently, X finished construction of a new tri-level building within M. All of the suite space is currently leased for use as medical offices and/or related services.

X contracts with an independent leasing agent to assist in soliciting prospective tenants for M, negotiating leases and renewals, and overseeing post-leasing activities such as build-outs and renovations of suite space. X, with the help of the independent leasing agent, drafts, proposes, presents, and negotiates letters of intent to lease available suite spaces. Negotiation for leasing regularly requires the use of an independent space planner to design and tailor the spaces for prospective tenants. Once letters of intent are accepted, X, with the help of the independent leasing agent, prepares, finalizes, and executes the lease agreements with prospective tenants. Renewals of leases are similarly handled by X, which are often complicated by requests for concessions and renegotiation of the leasing rate. Renewals often require X's significant time and attention.

X, through its employees, its agents, and the agents' employees, provides certain services in maintaining and repairing M's buildings, common areas, and grounds. Under a standard lease agreement for its tenants, X must provide certain services relating to the leasing of space within M and to maintain or repair the following items: the HVAC systems, plumbing, hot water heaters, exterior lighting, signs, lawn care and gardening, roofs and exterior walls, exterior walkways, courtyards, parking areas, electricity, water and sewer, drainage, and garbage pickup.

In addition, the following specific services are provided to M and its tenants by an employee or independent contractor/worker of X: daily walk-through inspections of M to report on water breaks, lighting outage, vandalism, damage to building exteriors and certain interior spaces; sweeping, cleaning and maintaining the common areas of M such as sideways, walkways, and parking lot; routine periodic inspection of building exteriors and interiors, including foundations, roofs, exterior lighting, grounds, and parking lot and engaging in maintenance and repairs as needed; treating the roofs of the buildings for moss growth yearly; recoating and resurfacing the parking lot; routine and periodic maintenance of the numerous heating and air conditioning units; renovating vacant suites for leasing; routine and periodic maintenance of the plumbing and sewer lines, and their repair and replacement as needed; maintenance, repair and replacement of exterior lighting and selected interior lighting; janitorial services for selected units and common areas; exterior window washing; regular maintenance of grounds and lawn care, and landscaping services when necessary; seasonal snow removal and ice control; weekly trash removal; periodic pest and vermin control; and emergency response and property access for public safety.

Based solely on the facts submitted and the representations made, the PLR concludes that the rental income X receives from its operations at the M development is not passive investment income under §1362(d)(3)(C)(i).

The PLR declares that it does not express an opinion on other federal tax consequences of X's operations, including whether X was or is a small business corporation under §1361(b). Further, the PLR points out that the §1362 passive investment income rules are independent of the §469 passive activity loss rules. Unless an exception under §469 applies, X's rental activity remains passive for purposes of §469.

PLR 201724012.

Medical malpractice insurance company's legally mandated payment to a fund to support graduate medical education in the state in which it operates is a deductible expense under §162(a). The PLR reasoned that the payment is necessary to the company's continued business operations and that it is made with an expectation of financial return, in that the fund is anticipated to increase both the size and quality of the state's medical industry (i.e., potential customers of company). IRS further concluded that the company was not required to capitalize the payment under §263(a).

Taxpayers may generally deduct all the ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. (§162(a); Regulation §1.162-1(a)) In order to be deductible under §162, an expenditure must be (1) paid or incurred during the tax year, (2) related to carrying on a trade or business, and (3) ordinary and necessary for the trade or business. (*Commissioner v. Lincoln Savings & Loan Assn.,* (S Ct 1971) 27 AFTR 2d 71-1542)
An expense is ordinary if it is customary or usual within a particular trade, business or industry or relates to a common or frequent transaction in the type of business involved. (*Deputy v. du Pont,* (S Ct 1940) 23 AFTR 808) A necessary expense is appropriate and helpful to the operation of the taxpayer's trade or business. (*Commissioner v. Tellier,* (S Ct 1966) 27 AFTR 2d 633) A payment may be appropriate and helpful to the development of a taxpayer's business if that payment is mandated by a state governmental entity which confers upon the taxpayer the right to conduct its business in that state. (*Rothner,* TC Memo. 1996- 442)

In Revenue Ruling 95-32, 1995-16 IRB 8, IRS ruled that payments by a public utility as part of programs to promote energy conservation and energy efficiency were business expenses that are deductible under §162. These programs were aimed at reducing electrical costs to the taxpayer's customers, as well as addressing environmental and societal concerns with the adverse environmental effects of increased electrical generation. These programs also enabled the taxpayer to reduce its future operating and capital costs.

Under §161, if a cost is a capital expenditure, the capitalization rules of §263 take precedence over the deduction rules of §162, and the expenditure cannot be deducted regardless of whether it is ordinary and necessary in carrying on a trade or business.

§263(a) generally prohibits deductions for capital expenditures. Regulation §1.263(a)-4 provides rules for applying §263(a) to amounts paid to acquire or create intangibles.

Association is a non-stock insurance company created by State Statute enacted in Year 1. With minor exceptions, every insurer authorized to write liability insurance on a direct basis within State is statutorily required to be a member of Association. Association is a taxable insurance company, the sole business of which is to write medical malpractice insurance for medical service providers and nursing homes in State. Since Year 4, Association has each year reported taxable income pursuant to §832. By statute, any after-tax operating profits of Association (except those attributable to insurance issued to nursing homes and assisted living facilities) are added to its surplus Reserve.

In Year 6, to attract more medical residents to State, State legislature created the State Fund to support grants to hospitals and medical schools in order to provide graduate medical education programs and create first-year residency positions. State Fund is funded in part by Association's Reserve. On Date 1, Association made Payment to the State Fund.

Association anticipates that it will benefit in a number of ways from State Fund. Notably, improvements to the quality and accessibility of graduate medical programs in State are anticipated to result in an increase in the number of medical professionals (i.e., potential customers for Association) who are generally better educated and thus less susceptible to malpractice claims.

Association requested rulings on the treatment of Payment to State fund-specifically, whether it is deductible as an ordinary and necessary business expense under §162(a), and whether it is not capitalized under §263(a).

IRS concluded that Association's Payment to the State Fund was deductible as an expense under §162(a).

IRS reasoned that Payment was an ordinary and necessary business expense, that it had a direct relationship to the industry in which Association operates, and that it was made with the expectation of financial return. Further, Payment to State Fund is a State law requirement, and failure to make it could jeopardize Association's continued business operations in State.

IRS then concluded that Association is not required to capitalize Payment under §263(a). Looking to Regulation §1.263(a)-4(b), IRS concluded that Payment: was not an amount paid to create or enhance a separate and distinct intangible asset (i.e., something capable of being sold); did not constitute an amount paid to acquire an intangible; was not made to create or enhance a future benefit identified in the Federal Register or Internal Revenue Bulletin; and was not made to facilitate the acquisition or creation of an intangible. Accordingly, Payment does not have to be capitalized.

PLR 201723009.

Tax consequences of an intercompany sale of an interest in a limited liability company (LLC) which was treated as a partnership for federal tax purposes, is examined where that sale resulted in the partnership's termination. The seller was treated as selling its partnership interest, and the buyer was treated as receiving the assets relating to the seller's interest in a partnership liquidation.

For tax purposes, a partnership is considered to continue despite changes in partners which may result in a technical dissolution under state law. It is considered as terminated only if: (1) the operations of the partnership are discontinued and no part of any business, financial operation or venture of the partnership continues to be carried on by the partners in any partnership; (§708(b)(1)(A)) or (2) within a 12-month period, there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. (§708(b)(1)(B)) This is sometimes called a "technical termination."

In Revenue Ruling 99-6, 1999-1 CB 432, IRS ruled that when a 2-member LLC that is treated as a partnership becomes a single-member LLC, the transaction is treated as a partnership termination in which the partnership is liquidated. Nevertheless, the selling member treats the transaction as the sale of a partnership interest and must report gain or loss under the §741 rules. Similarly, where all the interests in a 2-member LLC are sold to a new member, the selling members treat the transaction as the sale of their partnership interests and report gain or loss under the §741 rules.

Thus, in Revenue Ruling 99-6, where one partner sells his interest to the other partner, the seller is treated as selling his partnership interest and the buyer is treated as receiving the assets relating to the seller's interest in a partnership liquidation. Similarly, where one partner acquires the interests of both partners, the sellers are treated as selling their partnership interests, and the buyer is treated as receiving the assets relating to the seller's interest in a partnership liquidation. Accordingly, IRS ruled that the buyer did not have a tacked on holding period for the purchased portion.

Observation: Where, in a two-partner partnership, one of the partners buys the other partner's partnership interest, depending on the specific circumstances, other negative tax consequences are possible, including gain recognition upon the deemed partnership liquidation. These negative tax consequences (and the loss of the holding period) can be avoided by not terminating the partnership, i.e., by holding the partnership interests through two affiliated entities or by adding a minority partner.

Under §741, in the case of a sale or exchange of an interest in a partnership, gain or loss is recognized to the transferor partner. The gain or loss is considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in §751 (relating to unrealized receivables and inventory items). The amount of the gain or loss is the difference between the amount realized and the adjusted basis to the transferor of his partnership interest. (Regulation §1.741-1(a))

A partner's basis for property distributed in liquidation of his partnership interest is the same as the adjusted basis for his partnership interest reduced by any money distributed to him in the same transaction. However, the partner's basis in inventory and unrealized receivables cannot exceed the basis the partnership had in such items. (§732(b), §732(c), Regulation §1.732-1(b))

Generally, under the consolidated return's matching rule, for each consolidated return year, the separate-entity attributes of intercompany items of the member transferring property or providing services and the corresponding items of the member receiving the property or services are redetermined to the extent needed to produce the same effect on consolidated taxable income (and consolidated tax liability) as if they both were divisions of a single corporation and the intercompany transaction were a transaction between divisions. (Regulation §1.1502-13(c)(1)(i))

To the extent that the intercompany item of the transferor or member providing services and the corresponding item of the transferee or member for which services are provided do not offset in amount, the attributes redetermined under the matching rules must be allocated to the intercompany item and the corresponding item by using a method that is reasonable in light of all the facts and circumstances, including the purposes of the matching rule and any other rule affected by the attributes of the intercompany item and corresponding item. A method of allocation or redetermination is unreasonable if it is not used consistently by all members of the group from year to year. (Regulation §1.1502-13(c)(4))

Parent was a holding company and the common parent of an affiliated group of corporations (the Parent Group) that joined in the filing of a consolidated federal income tax return. The Parent Group was engaged in Business, largely through two chains of entities. Parent directly owned all of the membership interests in DE 1, an LLC disregarded from Parent for federal income tax purposes, and all of the stock of Sub 1. DE 1 owned all of the membership interests in DE 2, an LLC disregarded from Parent for federal income tax purposes. Sub 1 owned all of the stock of Sub 2, which owned all of the membership interests in DE 3, an LLC disregarded from Sub 2 for federal income tax purposes.

Prior to Date 1, DE 2 and DE 3 held all of the membership interests in PS 1, an LLC treated as a partnership for federal income tax purposes. All of PS 1's Class A membership interests were owned by DE 3, and all of PS 1's Class B membership interests were owned by DE 2. The assets of PS 1 consisted of interests in Facilities, each of which was owned by a special purpose entity, wholly-owned by PS 1 and disregarded from PS 1 for federal income tax purposes. At all times relevant, pursuant to the terms of the LLC Agreement, PS 1's items of income, gain, loss, deduction, and credit were allocated to DE 2 and DE 3.

On Date 1, pursuant to the Sales Agreement, DE 2 sold all of its Class B membership interests in PS 1 to DE 3 (the PS 1 Sale) for cash, and Parent had gain from the PS 1 Sale.

The following representations were made:

a. At the time of the PS 1 Sale, PS 1's assets consisted solely of the interests in the special purpose entities, the assets of which consisted solely of the Facilities and other trade or business assets related to the operation thereof; PS 1 (and its special purpose entities) had no liabilities, other than trade liabilities incurred in the ordinary course of its operation of the Facilities.

b. If the PS 1 assets which Sub 2 was treated as purchasing from Parent in the PS 1 Sale, had been distributed to Parent in a liquidating distribution to which §732(b) applied, Parent would not have recognized gain or loss on the distribution; the amount of cash (or cash equivalents) distributed would not have exceeded Parent's tax basis in its interest in PS 1.

c. The amount realized by Parent in the PS 1 Sale will be fully reflected in the bases of the assets that Sub 1 will be treated as purchasing from Parent in connection with the PS 1 Sale.

d. The Parent Group, Parent, and Sub 2 have maintained, and will continue to maintain, appropriate records with respect to all amounts of income, gain, and/or loss from the PS 1 Sale and with respect to all assets that reflect the federal income tax consequences to the Parent Group of the PS 1 Sale, in order to ensure that all items of income, gain, deduction and/or loss resulting from the PS 1 Sale will be appropriately accounted for and taken into account under the intercompany transaction regulations.

Based solely on the information submitted and the representations made, IRS ruled as follows:

1. Under §708(b)(1)(A), PS 1 terminated as a partnership as a result of the PS 1 Sale because PS 1 had a single owner, Sub 2. Under Revenue Ruling 99-6, Parent will treat the PS 1 Sale as a sale of its partnership interest in PS 1 to Sub 2 and will determine its income, gain, and/or loss under §741 and §751(a). Under §1001, the amount of Parent's gain or loss will be the difference between the amount realized by Parent with respect to its interest in PS 1 and Parent's adjusted basis in the interest in PS 1.

2. Under Revenue Ruling 99-6, PS 1 will be deemed to have made a liquidating distribution of all of its assets to Parent and Sub 2. Following this distribution, Sub 2 will be treated as purchasing the assets deemed to be distributed by PS 1 to Parent in liquidation of Parent's interest in PS 1. Under §1012, Sub 2's basis in the assets deemed purchased from Parent will be the purchase price paid for Parent's interest in PS 1.

3. The PS 1 Sale is an intercompany transaction as described in Regulation §1.1502-13(b)(1). Under Regulation §1.1502-13(b)(2), Parent's income, gain, and/or loss from the PS 1 Sale are its intercompany items. The amount of Parents income, gain, and/or loss from the PS 1 Sale (the intercompany items) will be accounted for under the matching rule of Regulation §1.1502-13(c).

4. Sub 2's corresponding items from the PS 1 Sale will be its items with respect to the assets that Sub 2 is treated as purchasing from Parent (in the manner described in Ruling (2) above). Sub 2's recomputed corresponding items will be determined based upon the respective bases that Parent would have had in the assets that Sub 2 is treated as purchasing from Parent (in the manner described in Ruling (2) above), had these assets been received in a liquidating distribution to which §732(b) applied.

5. The separate entity attributes of Parents intercompany items will be redetermined under Regulation §1.1502-13(c)(1)(i) and Regulation §1.1502-13(c)(4) by treating a proportionate amount of each of the items as allocable to the assets that Sub 2 is treated as purchasing from Parent (in the manner described in Ruling (2) above), based upon the difference between Sub 2's recomputed corresponding items and its corresponding items with respect to each of such assets, in order to produce the same effect on the Parent Group's consolidated taxable income (and consolidated tax liability) as if Parent and Sub 2 were divisions of a single corporation and the PS 1 Sale were between divisions of a single corporation.

PLR 201721014.

If the transaction at issue is treated as a reorganization, distribution of the stock of two subsidiaries as boot will be a distribution of property with respect to the stock of the parent corporation/target to which §301 applies. The excess of the amount of boot distributed with respect to a share of the parent corporation/target stock over the amount of the distribution treated as a dividend will be applied against and reduce the shareholder's adjusted basis in the share, with any remaining excess being treated as gain.

If a transaction qualifies as a reorganization under § §368(a)(1), then the exchange of stock or securities by shareholders or security holders in connection with the reorganization may qualify for full or partial nonrecognition of gain (or loss) under §354, §355, or §356.

No gain or loss is recognized by a corporation that is a party to a reorganization and that exchanges property solely for stock or securities of another corporation that is also a party to that reorganization. (§361(a)) If the corporation receives other property or money (boot) in addition to stock or securities, then if the corporation distributes all of the boot, it does not recognize gain on the exchange (but may recognize gain on the distribution of appreciated property).

However, if the corporation does not distribute any part of the boot, gain is recognized on the exchange to the extent of the undistributed boot. (§361(b)) If the acquiring corporation distributes property other than qualified property (defined in §361(c)(2)(B)), and the fair market value (FMV) of such property exceeds its adjusted basis, then gain will be recognized as if such property were sold to the distributee at its FMV. (§361(c)(2)(A))

§354 generally extends nonrecognition of gain or loss to certain exchanges of stock or securities in connection with reorganizations. No gain or loss will be recognized if stock or securities in a corporation that is a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation that is a party to the reorganization.

§355 provides for the separation without gain or loss recognition of one or more existing businesses formerly operated by one (distributing) corporation. (Regulation §1.355-1(b)) A divisive distribution that meets the requirements of §355 does not give rise to any income or to gain or loss to the shareholders or security holders, subject to exceptions. The distributing corporation also does not recognize gain or loss on the distribution of stock of the controlled corporation.

If the nonrecognition rules of §354 or §355 would apply to an exchange but for the fact that property other than stock or securities (i.e., boot) is also received in the exchange, gain is recognized only up to the sum of the money received and the FMV of the other property. (§356(a)(1)) Further, no loss is recognized on the exchange or distribution. (§356(c), Regulation §1.356-1(a)(1))

A corporation's distribution of property to its shareholder with respect to its stock is included in the shareholder's gross income to the extent the distribution is a dividend under §316 (i.e., a distribution out of a corporation's current and accumulated earnings and profits). (§301(c)(1)) To the extent the distribution is not a dividend, the shareholder reduces basis in the distributing corporation's stock, and any amount of the distribution in excess of the shareholder's basis is treated as gain from the sale or exchange of the corporation's stock. (§301(c)(2), §301(c)(3)) If a corporation distributes appreciated assets to a shareholder in a distribution to which §301 applies, the corporation recognizes gain (but not loss) as if the property were sold to the shareholder at its FMV. (§311(b))

Domestic Parent/Target is owned by two individuals, Shareholder 1 and Shareholder 2, who are married. Parent/Target owns greater than 80% of the stock of Corp 1 and Corp 2, which are members of Parent/Target's consolidated group. Parent/Target also owns less than 80% of the stock of Subsidiary/Acquiring. Accordingly, Subsidiary/Acquiring is not a member of Parent/Target's consolidated group.

Under the three-step Proposed Transaction:

Step (1). Parent/Target will exchange all of its common stock in Subsidiary (Old Stock) in exchange for voting common stock in Subsidiary (New Stock). Subsidiary/Acquiring will neither assume any of Parent/Target's liabilities nor receive any of Parent/Target's assets subject to liabilities. Shareholder 1 may contribute cash to the capital of Parent/Target to enable it to pay off liabilities. Alternatively, Shareholder 1 may pay or assume liabilities of Parent/Target.

Step (2). Parent/Target will convert to a limited liability company. No election will be made for Parent/Target to be taxed as a corporation.

Step (3). Shareholder 1 and Shareholder 2 may, in the future, transfer some of their Subsidiary/Acquiring stock to tax-exempt organizations. There is no plan to make these transfers at this time.

In the PLR, IRS ruled that, provided Steps (1) and (2), above, qualify as a reorganization under §368(a)(1):

a. The distribution of Corp 1 and Corp 2 stock (Boot) will be a distribution of property with respect to the stock of Parent/Target to which §301 applies. (§356(a), Regulation §1.356-1(a)) The excess, if any, of the amount of Boot distributed with respect to a share of Parent/Target stock over the amount of such distribution treated as a dividend will be applied against and reduce the shareholder's adjusted basis in the share, and any remaining excess will be treated as gain from the sale or exchange of property (§301(c)(2), §301(c)(3)); and

b. Gain will be recognized to Parent/Target as if it sold the Boot to its shareholders at its FMV on the date of the reorganization. (§361(c)(2))

PLR 201717010.

C corporation, that had a patent on a particular medical test and was in the business of analyzing the results of the test and preparing laboratory reports for health providers, was a qualified trade or business for purposes of the small business stock gain exclusion. The PLR came to this result because it held that the taxpayer was not in a trade or business of performing services in the health field or one in which the principal asset of the trade or business was the reputation or skill of its employees.

A taxpayer (other than a corporation) may exclude all (or, in some cases, part) of the gain realized on the disposition of qualified small business stock held for more than five years. (§1202(a))

§1202(c)(2) provides that stock in a corporation is not treated as qualified small business stock unless, during substantially all of the taxpayer's holding period for such stock, the corporation meets the active business requirements of §1202(e) and the corporation is a C corporation.

Under §1202(e)(3), a qualified trade or business generally does not include: a) a trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services; and b) any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.

The taxpayer was a founder of Company and serves as its chairman and CEO.

Company, a C corporation, developed a tool to provide more complete and timely information to healthcare providers. Company uses proprietary X and other technologies for the precise detection of B. Company is the only person or entity that can legally perform X testing, and its expertise is limited to its patented X testing.

Company analyzes the results of X testing and then prepares laboratory reports for healthcare providers. Company's clients are doctors and other healthcare providers. The information the Company provides in a typical laboratory report only includes a summary of z detected and z tested for and not detected. Company's laboratory reports do not diagnose or recommend treatment. Company does not discuss diagnosis or treatment with any healthcare provider and is not informed by the healthcare provider as to the healthcare provider's diagnosis or treatment. Company's sole function is to provide healthcare providers with a copy of its laboratory report.

Company accepts orders for tests only from health care professionals. Patients cannot order tests from Company. Although Company in rare instances may provide a copy of a test to a patient, it does not explain its laboratory reports to patients. Instead, Company directs patients to contact their healthcare provider if they have any questions. The only other contact Company has with a patient is in certain billing situations.

Company's laboratory director is required to be an M.D., D.O. or a Ph. D. as required by the laboratory personnel requirement of 42 C.F.R. §493.1441 et seq. The laboratory director reviews results for quality control and quality assurance. Other than the laboratory director, Company's laboratory personnel are not subject to state licensing requirements or classified as healthcare professionals by any applicable state or federal law or regulatory authority. The laboratory director never has direct contact with patients, and none of the Company's personnel diagnose, treat or manage any aspect of any patient's care.

Company's employees, who are well educated, receive up to a year of training to perform the X testing. However, the skills employees bring with them when Company hires them are almost useless when performing the X tests, and the skills they acquire at Company are not useful to other employers.

IRS concluded that Company is engaged in a qualified trade or business under §1202(e)(3) because it is not in a trade or business (i) involving the performance of services in the field of health or (ii) where the principal asset of the trade or business is the reputation or skill of one or more of its employees.

IRS noted that none of Company's revenue is earned in connection with patients' medical care. Although Company's laboratory reports provide valuable information to healthcare providers, Company does not provide health care professionals with diagnosis or treatment recommendations for treating a healthcare professional's patients, nor is Company aware of the health care provider's diagnosis or treatment of the healthcare provider's patients. In addition, the skills that Company's employees have are unique to the work they perform for Company and are not useful to other employers.

PLR 201714028.

Liabilities that will be assumed by a partnership (through a disregarded entity) in connection with a company's transfer of substantially all of its assets and liabilities to the partnership will be qualified liabilities under Regulation §1.707-5(a)(6)(i)(E).

Under the disguised sale rule, if there's (1) a direct or indirect transfer of money or other property by a partner to a partnership, (2) a related direct or indirect property transfer by the partnership to the same partner or another partner, and (3) the transfers viewed together are properly characterized as a sale or exchange, then they'll be treated under regulations as either a transaction between the partnership and an outsider under §707(a) or as a transaction between two or more partners acting other than in their capacity as partners. (§707(a)(2)(B))

If a partnership assumes or takes property subject to liability of a partner that is not a qualified liability, the partnership is treated as transferring consideration to the partner to the extent the amount of the liability exceeds the partner's share of the liability immediately after the partnership assumes or takes the property subject to the liability. (Regulation §1.707-5(a)(1))

Under Regulation §1.707-5(a)(5)(i), if a transfer of property by a partner to a partnership is not otherwise treated as part of a sale, the partnership's assumption of or taking subject to a qualified liability in connection with a transfer of property is not treated as part of a sale.

A liability assumed by (or taken subject to) a partnership in connection with a transfer of property to the partnership by a partner is a qualified liability if:

1. The liability was incurred by the partner more than two years before the earlier of the date the partner agreed in writing to transfer the property or the date the partner transfers the property to the partnership, provided the liability encumbered the property throughout the 2-year period;

2. The liability was incurred by the partner within the 2-year period, provided the liability was not incurred in anticipation of the transfer of the property to the partnership. (However, there is a presumption that a liability incurred within the 2-year period was incurred in anticipation of the transfer unless the facts and circumstances clearly show otherwise. (Regulation §1.707-5(a)(7));

3. The liability is, under the rules of Regulation §1.163-8T (relating to the allocation of debt for purposes of the limitations on the interest deduction), allocable to capital expenditures with respect to the property;

4. The liability was incurred in the ordinary course of the trade or business in which the property transferred to the partnership was used or held, but only if all the assets related to that trade or business are transferred to the partnership other than assets that are not material to the continuation of the trade or business; or

5. The liability was not incurred in anticipation of the transfer of the property to a partnership but was incurred in connection with a trade or business in which property transferred to the partnership was used or held, but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business. (Regulation §1.707-5(a)(6))

In addition, if the liability is a recourse liability, to be a qualified liability, it cannot exceed the fair market value of the transferred property (less the amount of any other liabilities that are senior in priority and that either encumber the property or are liabilities described in (3) or (4), above) at the time of the transfer). (Regulation §1.707-5(a)(6)(ii))

Company (including its subsidiaries that are disregarded as entities separate from Company for federal tax purposes) is planning to transfer cash, all of its material operating assets, and its currently owned Special Class of Interests in Partnership to Partnership (through DRE, which is disregarded as an entity separate from Partnership) in exchange for additional limited partner units and new Special Class of Interests in Partnership (the "Transfer"). In connection with the Transfer, Partnership (through DRE) will assume a certain amount of Company's liabilities (the "Liabilities"), and Partnership's limited partnership agreement will be amended to provide that distributions in respect of the new Special Class of Interests will be reduced by up to a specified amount each year for the first three years following the Transfer, depending on whether Partnership's total cash distributions for each year exceed its distributable cash flow.

All of the Liabilities were incurred years before the proposed Transfer. Some of the Liabilities were originally incurred to make distributions in connection with Company's formation and have been subsequently refinanced. The remaining balance of the Liabilities have been used to acquire assets, make improvements, pay expenses, and otherwise operate Company's business and that of its subsidiaries, including to refinance other liabilities incurred for the same purposes. Company has also regularly distributed cash to its members in proportion to their ownership interests. Those cash distributions, however, have been less than Company's earnings. The Liabilities (and the liabilities they refinanced) are an integral part of Company's existing and historical capital structure.

Company makes the following representations:

a. None of the Liabilities is in default;

b. The Liabilities were not incurred in anticipation of the Transfer to Partnership;

c. The Transfer to Partnership was not being considered at the time the Liabilities were incurred;

d. Company would have incurred the Liabilities without regard to the Transfer to Partnership; and

e. There will not be a shift in the ownership of the capital of Partnership associated with the Transfer, and the amount of cash deemed to be distributed under §752(b) (if any) upon the assumption of the Liabilities will not exceed Company's basis in its interests in Partnership, nor will there be a reduction in Company's interests in Partnership's unrealized receivables (under §751(c)) and inventory items (under §751(d)) in connection with the Transfer. For this purpose, a "shift in the ownership of capital" means a change by reason of a partner's giving up any part of his right to be repaid the amount in his capital account (after adjustment under Regulation §1.704-1(b)(2)(iv)(f)) in favor of one or more other partners.

In the PLR, IRS concluded that the Liabilities assumed by Partnership (through DRE) in connection with Company's Transfer to Partnership would constitute qualified liabilities of Company under Regulation §1.707- 5(a)(6)(i)(E).

However, IRS did not rule on whether Company's Transfer would otherwise constitute a disguised sale of property to Partnership under §707(a)(2)(B) or on the tax consequences of any exchange of Company's Special Class of Interests with Partnership.

PLR 201710008.

Following a merger of three securities partnerships, the surviving partnership may aggregate built-in gains and losses from qualified financial assets contributed by the terminating partnerships, with gains and losses from revaluations of qualified financial assets held by the surviving partnership, for purposes of making both regular and reverse §704(c) allocations.

If a partner's distributive share of an item or class of items is not provided for in the partnership agreement, or if the allocation of that item or class of items under the agreement does not have substantial economic effect, the partner's distributive share must be determined in accordance with the partners' interests in the partnership, taking into account all the facts and circumstances. (§704(b))

§704(c) requires partnerships to allocate income, gain, loss, and deductions for property contributed by a partner so as to take into account variations between the property's adjusted tax basis and its fair market value (FMV) at the time of contribution.

The §704(c) principles for contributed property also apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property under Regulation §1.704-1(b)(2)(iv)(f). These are known as "reverse §704(c) allocations."

For both regular and reverse §704(c) allocations, the allocations must be made using a reasonable method that's consistent with §704(c) 's purpose of preventing the shifting of tax consequences from pre-contribution gain or loss among partners. (Regulation §1.704-3(a)(1)) An allocation method is not reasonable if the contribution of property (or other event resulting in reverse §704(c) allocations) and corresponding allocation of tax items are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

§704(c) generally applies on a property-by-property basis. (Regulation §1.704-3(a)(2)) Thus, in determining whether there is a disparity between the adjusted tax basis and FMV, the built-in gains and losses on items on contributed property cannot be aggregated. However, under Regulation §1.704-3(e)(3), certain securities partnerships can make reverse allocations by aggregating gains and losses from qualified financial assets using any reasonable approach that is consistent with §704(c) 's purposes.

A securities partnership is either a management company or an investment partnership, and makes all of its book allocations in proportion to the partners' relative book capital accounts. (Regulation §1.704-3(e)(3)(iii)(A)) Qualified financial assets are any personal property (including stock) that is actively traded. (Regulation §1.704-3(e)(3)(ii)(A))

The partial netting approach (under which gains and losses are aggregated separately, Regulation §1.704-3(e)(3)(iv)) and full netting approach (under which gains and losses are netted, Regulation §1.704-3(e)(3)(v)) are generally considered reasonable.

The aggregation rules of Regulation §1.704-3(e)(3) generally apply only to reverse §704(c) allocations. Thus, a securities partnership using an aggregate approach must generally account for any built-in gain or loss from contributed property separately in order to avoid substantial distortions in the character and timing of income and loss recognized by contributing partners. However, in situations where the likelihood of character and timing distortions is minimal and the burden of making §704(c) allocations separate from reverse §704(c) allocations is great, IRS can permit (via published guidance or letter ruling) aggregation of qualified financial assets for purposes of §704(c) allocations in the same manner as that described in Regulation §1.704-3(e)(3). (Preamble to TD 8585, 12/27/1994)

If two or more partnerships merge or consolidate into one partnership, the resulting partnership is treated as a continuation of the merging or consolidating partnership whose members own an interest of more than 50% in the capital and profits of the resulting partnership. (§708(b)(2)(A))

When two or more partnerships merge or consolidate into one partnership without undertaking a form for the merger or consolidation, or undertake a form for the merger that is not an assets-up form, any merged or consolidated partnership that is considered terminated is treated as undertaking the assets-over form for tax purposes. (Regulation §1.708-1(c)(3)) Under the assets-over form, the merged or consolidated partnership that is considered terminated contributes all of its assets and liabilities to the resulting partnership in exchange for an interest in the resulting partnership, and immediately thereafter, the terminated partnership distributes interests in the resulting partnership to its partners in liquidation of the terminated partnership.

Surviving Partnership, Terminating Partnership A, and Terminating Partnership B are owned by identical or related parties in substantially similar proportions. To reduce the costs and burdens associated with the administration of the separate partnerships, the partnerships plan to merge.

Under the merger rules of Regulation §1.708-1(c), the resulting partnership will be deemed to be a continuation of Surviving Partnership, and Terminating Partnership A and Terminating Partnership B will be considered terminated. The merger will take the assets-over form as described in Regulation §1.708-1(c)(3). Therefore, Terminating Partnership A and Terminating Partnership B will contribute all of their assets and liabilities to Surviving Partnership in exchange for interests in Surviving Partnership, and immediately thereafter, Terminating Partnership A and Terminating Partnership B will distribute their interests in Surviving Partnership to their partners in liquidation.

After the merger, Surviving Partnership will qualify as a "securities partnership" as defined in Regulation §1.704-3(e)(3)(iii). Each partnership currently uses, and Surviving Partnership will continue to use, the partial netting approach described in Regulation §1.704-3(e)(3)(iv) for making reverse §704(c) allocations. Surviving Partnership will consistently apply the partial netting approach to all of its qualified financial assets for all tax years in which it qualifies as a securities partnership. The partial netting approach it adopted will preserve the tax attributes of each item of gain or loss it realizes and will not be used with a view to reducing substantially the present value of the partners' aggregate tax liability. Contributions of property (or the event that results in reverse §704(c) allocations) and the corresponding allocation of tax items with respect to the property will not be made with a view to shifting the tax consequences of built-in gain or loss among Surviving Partnership's partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

The burden to Surviving Partnership of making §704(c) allocations separately from reverse §704(c) allocations is substantial.

Under the authority of Regulation §1.704-3(e)(4)(iii), IRS has approved the aggregation of the qualified financial assets contributed by the terminating partnerships for purposes of making §704(c) allocations in the same manner as that described in Regulation §1.704-3(e)(3).

IRS said that its ruling is limited to allocations of gain or loss from the sale or other disposition of qualified financial assets made under §704(b), §704(c)(1)(A), and Regulation §1.704-3(a)(6). Surviving Partnership must maintain sufficient records to enable it and its partners to comply with §704(c)(1)(B) and §737 (Recognition of precontribution gain). Additionally, this ruling applies only to the contributions to Surviving Partnership made in connection with the mergers of Terminating Partnership A and Terminating Partnership B into Surviving Partnership and not to any other contributions or any other future partner.

However, in the event of a technical termination of Surviving Partnership under §708(b)(1)(B), the resulting partnership may continue to rely on this ruling.

Consequences of any exchange of Company's Special Class of Interests with Partnership.

PLR 201706010.

Corporation would qualify as successor employer for purposes of the annual wage limitations under §3121(a)(1) with respect to wages paid to certain employees who would become its employees in a corporate reorganization.

Under §3121(a)(1), an employer has no liability with respect to the Social Security tax portion of FICA for remuneration paid by the employer to an employee with respect to employment during the calendar year after the employer has paid wages to the employee equal to the contribution base for the year. This rule generally does not apply to wages for an employer where another employer has already paid wages to the employee equal to the contribution base during the calendar year.

However, the predecessor-successor rule in §3121(a)(1) provides an exception to the general rule that a new contribution base applies in the case of a second employer. Under §3121(a)(1), if an employer (successor) during any calendar year acquires substantially all the property used in a trade or business of another employer (predecessor), or used in a separate unit of a trade or business of a predecessor, and immediately after the acquisition employs in his trade or business an individual who immediately prior to the acquisition was employed in the trade or business of the predecessor, then, for the purpose of determining whether the successor employer has paid remuneration with respect to employment equal to the contribution base to such individual, any remuneration paid with respect to employment to such individual by the predecessor during that calendar year and before the acquisition is considered as having been paid by the successor.

Regulation §31.3121(a)(1)-1(b)(2) sets out three tests that must be met for the wages paid, by a predecessor to an employee, to be treated as having been paid to such employee by a successor for purposes of the annual wage limitation: (1) the successor during a calendar year acquired substantially all the property used in a trade or business, or used in a separate unit of a trade or business, of the predecessor; (2) such employee was employed in the trade or business of the predecessor immediately prior to the acquisition and is employed by the successor in the successor's trade or business immediately after the acquisition; and (3) such wages were paid during the calendar year in which the acquisition occurred and prior to such acquisition.

Regulation §31.3121(a)(1)-1(b)(4) provides that substantially all of the property used in a separate unit of a trade or business may consist of substantially all the property used in the performance of an essential operation of a trade or business, or it may consist of substantially all the property used in a relatively self-sustaining entity which forms a part of the trade or business. Revenue Ruling 72-269, 1972-1 CB 313, concludes that a successor employer meets the requirement to acquire substantially all the assets in a separate unit of a trade or business (or essential operation), if the successor employer acquires the use of the property used by the predecessor in the essential operation.

For the purposes of employment taxes, the term "employee" includes "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee." (§3121(d)(2))

Corporation Y and Corporations L, M, N and O are subsidiaries of Parent. In the Transaction, on a date to be determined in Year One after January 1, Corporations L, M, N and O will transfer their respective Function A Support Employees to Corporation Y, a shared service entity. On the same date as the transfer of employees, Corporations L, M, N and O will also transfer to Corporation Y substantially all those operating assets owned by them that are determined to relate to the Function A Support Employees being transferred to Corporation Y. Also, on the same date, Corporation Y will succeed to the leasing, contractual or similar intercompany arrangements with regard to the assets that are owned by Parent's other affiliates and used by the Function A Support Employees.

Immediately after the Transaction, the Function A Support Employees who have transferred will continue to perform their functions supporting Business Employees and business activities of the subsidiary from which they have transferred and other affiliates of the Parent in the same capacity and manner as prior to the transfer. The transferred employees will have the same use of all the assets used in the Function A Support Functions, either through ownership transfer of the assets or through transfer of leasing, contractual or similar intercompany arrangements which the employees were using prior to the transfer.

The taxpayer represents that:

a. 100% of the Function A Support Employees of Corporations M and N are common law employees of their respective Corporation before the transfer and the employees will be transferred to Corporation Y and immediately become the common law employees of Corporation Y. This transfer includes all supervisors and managers within the Function A Support Functions at Corporations M and N. Thus, at the conclusion of the Transaction, 100% of the Function A Support Employees formerly employed by Corporation M and Corporation N will be employed by Corporation Y and will be under the supervision and direction of supervisors and managers employed by Corporation Y.

b. 100% of the Function A Support Employees of Corporations L and O are common law employees of their respective Corporation before the transfer and between F% and G% of the Function A Support Employees will be transferred to Corporation Y and immediately become the common law employees of Corporation Y. Corporations L and O are subject to legal requirements that may limit the transfer of certain employees. This transfer of the Function A Support Employees will include all supervisors and managers within the Function A Support Functions at Corporations L and O, except as limited by legal requirements. Thus, at the conclusion of the Transaction, between F% and G% of the Function A Support Employees formerly employed by Corporation L and O will be employed by Corporation Y and will be under the supervision and direction of supervisors and managers employed by Corporation Y.

In the PLR, IRS determined that, with regard to the Transaction, Corporation Y was a successor employer of Corporations L, M, N and O for purposes of the annual wage limitations contained in §3121(a)(1). IRS found that the taxpayer met the three requirements in Regulation §31.3121(a)(1)-1(b)(2) for the wages paid by a predecessor to an employee to be treated as having been paid to such employee by a successor for purposes of the annual wage limitation.

IRS reasoned that the first test is met because Corporation Y has acquired substantially all the assets of an essential operation of Corporations L, M, N and O because it met the test in Revenue Ruling 72-269. It is represented that Corporations L, M, N and O will transfer to Corporation Y all those operating assets owned by each respective Corporation that are determined to relate to their respective Function A Support Employees. Corporation Y will also succeed to the leasing, contractual, or similar intercompany arrangements with regard to the assets that are owned by the taxpayer's other affiliates and used by the

Function A Support Employees. IRS concluded that based on the specific facts presented, the Function A Support Functions constitute essential operations of Corporations L, M, N and O because the operations are necessary to complete or support a process executed by Business Employees or other Support Employees in the conduct of their activities and to enable Parent to meet all of its management, administration, reporting, compliance, legal, financial, risk, technological, and operational obligations that are germane to Parent's business. The Function A Support Functions are distinct and substantial operations that provide activities that are essential for the operations of Corporations L, M, N and O.

IRS found that the second requirement is met because Parent has represented that the Function A Support Employees being transferred are the common law employees of Corporations L, M, N and O in the Function A Support Functions' trade or business of Corporations L, M, N and O immediately before the acquisition and will be common law employees of Corporation Y in Corporation Y's trade or business immediately after the acquisition.

IRS also concluded that the third requirement is met. According to the taxpayer, because of the date of the acquisition, wages will be paid by the predecessor during the calendar year in which the acquisition will occur and prior to such acquisition.

PLR 201647007; PLR 201646004.

In two substantially similar Technical Advice Memorandums (TAMs), IRS has determined that a television Subscription Package sold by a "Multichannel Video Programming Distributor" is not a "qualified film" for purposes of the §199 domestic production activities deduction and that gross receipts derived by the distributor from its Packages are not domestic production gross receipts.

Under §199, taxpayers may claim a deduction to offset income from domestic manufacturing and other domestic production activities (the "domestic production activities deduction," or DPAD). In general, the DPAD equals 9% of the smaller of the taxpayer's: (a) qualified production activities income for the tax year, or (b) taxable income (modified adjusted gross income, for individual taxpayers), without regard to the §199 deduction, for the tax year.

Qualified production activities income is DPGR less cost of goods sold allocable to DPGR, less other expenses, losses, or deductions properly allocable to DPGR. (§199(c)(1)) DPGR includes the gross receipts of the taxpayer which are derived from, among other things, the disposition, lease, rental, etc. of a qualified film which was produced by the taxpayer in whole or in significant part within the U.S. (§199(c)(4)(A)(i)(I), Regulation §1.199-3(j))

§199(c)(6) defines the term "qualified film" as any property described in §168(f)(3) (generally, any motion picture film or video tape) if not less than 50% of the total compensation relating to the production of such property is compensation for services performed in the U.S. by actors, production personnel, directors, and producers. Further guidance on what constitutes a "qualified film" is provided in the regulations, including that the term encompass "live or delayed television programming." (Regulation §1.199-3(k)).

Taxpayer is a multichannel video programming distributor (MVPD) regulated by the Federal Communications Commission (FCC) as a telecommunications service provider. In exchange for various monthly fees, Taxpayer distributed to customers, via the transmission of Signals, thousands of channels containing television programs, advertisements, and interstitials. The television content Taxpayer's customers received varied depending on their Subscription Package and geographic location.

Some of Taxpayer's Subscription Packages included access to channels containing films and television programs. In addition, Taxpayer provided customers access to pay-per-view films and television programs. Taxpayer also provided customers the equipment necessary to receive the Signals transmitted by Taxpayer.

Almost all of the television channels that Taxpayer distributed to customers were licensed from unrelated third parties. During the years at issue, Taxpayer also produced television programs for a number of the television channels it distributed, but a significant portion of the content provided on these channels was also licensed from unrelated third parties.

Taxpayer claimed §199 deductions in an undisclosed amount during the years at issue based on its assertion that each of its Subscription Packages is a new film that is also a qualified film produced by Taxpayer, and so the various monthly fees paid to Taxpayer in exchange for access to its Subscription Packages qualify as DPGR under §199(c)(4)(A)(i)(II) and Regulation §1.199-3(k).

IRS's Large Business and International Division (LB&I), on the other hand, asserted that a package of television channels is not a film and thus not a "qualified film" under §199. LB&I claimed that the use of the term "film" in §199 and its regulations is limited to individual films, and that the only gross receipts of Taxpayer that are DPGR are those, if any, that are derived from individual films that are components of a Subscription Package that meet the requirements to be a qualified film produced by Taxpayer.

The TAM concluded that a Subscription Package does not qualify as a qualified film. Notably, it is not "any motion picture film or video tape" under the unambiguous statutory language in §168(f)(3) -or even under "the most liberal reading of the phrase." Rather, IRS views each individual film included in a Subscription Package as a "motion picture film or video tape." IRS further concluded that, while Regulation §1.199-3(k)(1) includes "live or delayed television programming" within the definition of a film, this refers to individual television programs that are broadcast live or on a delayed basis, and not a package of programs.

The TAM also cited to the legislative history underlying §199, which shows that Congress intended to limit the tax benefits of §199 to film production, and not film distribution, in an attempt to encourage domestic film production. Taxpayer's generation and transmission of Signals to distribute a Subscription Package does not result in any new programming content.

The TAM then determined that, because a Subscription Package is not a "qualified film," gross receipts derived from Subscription Packages were not DPGR. However, the TAM stated that individual films that are a component of Taxpayer's Subscription Packages could potentially give rise to DPGR. While Taxpayer licensed nearly all of the television channels included in its Subscription Packages from unrelated third parties, it did produce a limited number of programs. So, if Taxpayer can show that these programs meet the definition of qualified films, were produced by Taxpayer, and satisfy all other requirements, Taxpayer may be able to include gross receipts from these programs as DPGR.

Legal Advice Issued by Field Attorneys 20171601F.

Taxpayer's method of determining the amount of employee wages spent on in-house research expenses qualifying for the §41 research credit was rejected. The method was based on statistical analysis that did not produce an appropriate measure of the taxpayer's in-house research expenses.

§41 provides credits for increasing research activities. The amount of the credit is a function of a taxpayer's qualified research expenditures (QREs), which include a taxpayer's in-house research expenses. (§41(b)(1)) In-house research expenses include wages paid to an employee for qualified services, which are services consisting of engaging in qualified research or engaging in the direct supervision or support of research activities which constitute qualified research. (§41(b)(2)(B))

However, wages incurred for an employee constitute in-house research expenses only to the extent the wages are incurred for qualified services performed by the employee. If an employee performs both qualified and non-qualified services, only the amount of wages allocable to the performance of qualified services constitutes an in-house research expense. (Regulation §1.41-2(d)(1))

In the absence of another allocation method that a taxpayer can demonstrate to be more appropriate, the amount of in-house research expense is determined by multiplying the total amount of wages paid to or incurred for the employee during the tax year by the ratio of the total time actually spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the tax year. (Regulation §1.41-2(d)(1))

Taxpayer claimed credits for increasing research activities for four tax years. Taxpayer believed it was entitled to these credits because it incurred QREs when it accrued liabilities for employees' wages for performing qualified services. Taxpayer incurred liabilities for wages owed to its employees for the performance of qualified and nonqualified services, but it did not maintain records reflecting the cost of its qualified services or the amount of time its employees spent performing qualified services. Also, Taxpayer never determined how much time its employees spent performing qualified services on a particular project.

Taxpayer did not compute the amount of in-house research expenses using the method provided in Regulation §1.41-2(d)(1). Instead, it estimated the amount of its liability for wages incurred for qualified services through a two-step process:

1. Taxpayer estimated the portion of the total liability for wages it incurred for the performance of qualified services. Its controller identified which employees he believed to have performed qualified services at any time during the tax year. The controller then estimated the fraction of each employee's time that the employee spent performing qualified services. This fraction was multiplied by the employee's total wages for the year. The resulting product represented Taxpayer's estimate of the total amount of a particular employee's wages for the time spent performing qualified services. The controller then added the amounts calculated for each employee to calculate his initial estimate of total wages incurred for qualified services.

2. Taxpayer multiplied the estimate it calculated in step (1), above, by a fraction. The denominator of the fraction was the number of projects that Taxpayer believed to involve more than 50 hours of work by employees and that might have involved at least one employee who conducted qualified research during some part of the project. The numerator was a subset of the projects in the denominator with respect to which Taxpayer, after investigating a random sample of the projects, determined that an employee performed qualified research during some part of the project.

Taxpayer determined that roughly 52% of the projects described by the denominator of this fraction (i.e., in step (2)) involved an employee engaged in qualified research at some point. In analyzing this sample, Taxpayer only considered whether the project involved qualified research at some point and did not determine what percentage of total project costs, such as wages, were attributable to the performance of qualified services.

Taxpayer did not explain why it multiplied its estimate from step (1) by this fraction. It appears that it did so to correct for the fact that its controller's estimates may have been inaccurate. As the controller only estimated how much time Taxpayer's employees performed qualified services based on his understanding of how the employees spent their time, the controller may have included time spent on activities that were not related to qualified research, even if the activities may have resembled the performance of qualified services. Consequently, this adjusted estimate supposedly reflected the cost of Taxpayer's employees doing activities resembling research, but reduced by the fraction of Taxpayer's projects that did not involve qualified research.

The LAFA concludes that Taxpayer's allocation method to determine the amount of time spent on in-house research projects was not more appropriate than the one prescribed by Regulation §1.41-2(d)(1).

The underlying methodology of Taxpayer's first step may have been appropriate (although the LAFA does not opine on the quality of the evidence on which it was based, whether there was a reasonable basis for the estimates claimed, or whether there was evidence to substantiate the claimed credits). By contrast, the methodology of Taxpayer's second step was inappropriate as it multiplied the product determined in the first step of its analysis by a fraction derived from a statistical analysis.

Taxpayer did not determine the amount of QREs incurred in connection with a sampled project. Instead, its sample merely concludes that approximately 52% of the projects it considered involved some qualified research. The LAFA concludes that there was no basis for Taxpayer to apply this percentage against an estimate of potentially qualifying wages and use that result to compute the credit.

Determining that a project involves qualified research does not mean that the amount of expenses, such as wages incurred in connection with the project, are QREs. Taxpayer determined the amount of its in-house research expense, in part, based on a ratio of projects that allegedly involved the performance of qualified services to all projects that Taxpayer thought may have involved the performance of qualified services. Because the scope of research activities and associated expenses (including in-house research expenses) may differ significantly from project to project, the LAFA concludes that Taxpayer's approach did not produce an appropriate measure of its in-house research expenses.

The LAFA presents the following example to illustrate the methodological flaw of Taxpayer's applying the results of the statistical analysis of what portion of its projects involved qualified research to adjust the amount of its wage expenses initially estimated to be QREs.

T employs 100 employees who conduct 50 projects in the year at issue. Total wage expense for the year is $1 million. T conducts an analysis similar to that employed by Taxpayer. In the first step, T approximates the amount of its liability for employees' wages that was incurred for the performance of qualified services. T estimates the ratio of how much time each employee performed qualified services to how much total time each employee spent working for T during the year. T then multiplies this ratio by the employee's wages for the year. In conducting this step, T estimates that $100,000 of wages it incurred for the year should be considered incurred for qualified services.

But, T cannot determine what portion of its employees' time was actually spent performing qualified services on a specific project, since T did not track this information. To adjust for the fact that its estimates may have been inaccurate, T conducts a second step, in which it analyzes a random sample of two projects its employees conducted, Project A and Project B, to determine whether its employees engaged in qualified research at some point during those projects. Project A involved employees who engaged in qualified research. Project B did not. Therefore, T concludes that 50% of its projects involve qualified research.

T then multiplies its $100,000 estimate of wages that were incurred for the performance of qualified services by 50% and concludes that it incurred $50,000 in QREs for the year.

But assume further that T actually incurred $3,000 and $7,000 in wage expenses on Projects A and B, respectively. Even assuming that all of T's wage expenses related to Project A are QREs, only 30% ($3,000 /($3,000 + $7,000)) of T's wage expenses are QREs.

If T were to multiply its $100,000 estimate of its wage expenses that were incurred for the performance of qualified services by this 30%, it would conclude that it incurred only $30,000 in QREs for the year.

Accordingly, the LAFA points out that if T had sampled the portion of its expenses that were related to qualified research, not the portion of projects, it would have concluded that a different portion of its expenses were QREs. As the illustration shows, the conclusion Taxpayer draws from its analysis is illogical. Taxpayer reached a conclusion about the portion of its expenses that represented QREs based on an analysis of the portion of its projects that involved qualified research. But some of

Taxpayer's projects may cost more or less than others. Because a certain portion of projects involve qualified research does not mean that the same portion of expenses are QREs.

In sum, the LAFA concludes that Taxpayer did not demonstrate that its method of allocation was more appropriate than the method in Regulation §1.41-2(d)(1). Accordingly, Taxpayer must determine the amount of in-house research expense by multiplying the total amount of wages incurred for the employee during the tax year by the ratio of the total time actually spent by the employee in the performance of qualified services for Taxpayer to the total time spent by the employee in the performance of all services for Taxpayer during the tax year.

Notice 2017-47, 2017-38 IRB ; IR 2017-141

Penalty relief to partnerships that filed certain untimely returns, or untimely requests for an extension of time to file those returns, for the first tax year that began after December 31, 2015, by the 15th day of the 4th month following the close of that tax year. Thus, the Notice provides penalty relief for certain partnerships that did not file the required returns by the new due date for tax years beginning in 2016.

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (Surface Transportation Act, PL 114-410) included a major restructuring of entity return due dates, effective generally for returns for tax years beginning after December 31, 2015.

Among the changes the Surface Transportation Act made, it provided that a partnership return-Form 1065 (U.S. Return of Partnership Income)-has to be filed by the 15th day of the 3rd month after the end of the tax year. Thus, partnerships with a calendar year have to file by March 15 of the following year. (§6072(b), as amended by Surface Transportation Act §2006(a))

Under pre-Surface Transportation Act, the due date for filing the annual return of a partnership had been the 15th day of the 4th month following the close of the tax year (April 15 for calendar-year taxpayers).

Partnerships filing Form 1065 and Form 1065 B (U.S. Return of Income for Electing Large Partnerships) are affected by the Surface Transportation Act amendment. These partnerships may also file Form 8804 (Annual Return for Partnership Withholding Tax (Section 1446)) and Form 8805 (Foreign Partner's Information Statement of Section 1446 Withholding Tax), which are generally due to IRS on the same date as the partnership's Form 1065 or Form 1065-B.

Filers of Form 1065 must furnish their partners with Schedules K-1 (Partner's Share of Income, Deductions, Credits, etc.) by the due date of the Form 1065, and filers of Form 1065-B must furnish their partners with Schedules K-1 by the first March 15 following the close of the partnership's tax year. Filers of Form 8804 that are required to file Forms 8805 must also furnish their partners with their respective copies of Forms 8805 by the due date of the Form 8804. Some partnerships must also file additional returns, such as Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations) by the due date of the Form 1065 or Form 1065-B.

Partnerships can obtain a 6-month extension of time to file Form 1065, 1065 B, or 8804 by filing Form 7004 (Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns) by the statutory due date of those returns. Partnerships that receive an extension of time to file Form 1065 receive a concurrent extension of time to furnish their partners with Schedules K-1. Also, partnerships that receive an extension of time to file Form 8804 receive concurrent extensions of time to file Forms 8805 and to furnish respective copies of the Forms 8805 to their partners.

The 6-month extension may apply to additional returns that partnerships may be required to file by the due date of their Forms 1065 or 1065-B, but it does not affect the due date for partnerships filing Form 1065-B to furnish their partners with Schedules K-1.

Partnerships that fail to timely meet their obligations to file and furnish returns are subject to penalties:

Partnerships that fail to file Form 1065, 1065-B, or 8804 by the due date (with regard to extensions) are subject to penalty under §6698 or §6651.

Partnerships that fail to file Forms 8805 by the due date (with regard to extensions) are subject to penalty under §6721.

Partnerships that fail to furnish Schedules K-1 or the partner copies of Forms 8805 by the due date are subject to penalty under §6722.

Partnerships that fail to file Form 5471 by the due date are subject to penalty under §6038 or §6679.

Partnerships that fail to file additional returns that they are required to file by the due date of their Forms 1065 or 1065-B may also be subject to other penalties.

Many partnerships filed the returns discussed above or Form 7004 for the first tax year beginning after December 31, 2015, by the date previously required by §6072. If not for the Surface Transportation Act (i.e., under prior law), these returns and requests for an extension of time to file would have been timely.

IRS will grant relief from the penalties described above for any return described above for the first tax year of any partnership that began after December 31, 2015, if:

1. The partnership filed the Form 1065, 1065-B, 8804, 8805, 5471, or other return required to be filed with IRS and furnished copies (or Schedules K-1) to the partners (as appropriate) by the date that would have been timely under §6072 before amendment by the Surface Transportation Act (i.e., April 18, 2017 for calendar-year taxpayers, because April 15 was a Saturday and April 17 was a legal holiday in the District of Columbia); or
2. The partnership filed Form 7004 to request an extension of time to file by the date that would have been timely under §6072 before amendment by the Surface Transportation Act and files the return with IRS and furnishes copies (or Schedules K-1) to the partners (as appropriate) by the 15th day of the 9th month after the close of the partnership's tax year (September 15, 2017, for calendar-year taxpayers). If the partnership files Form 1065-B and was required to furnish Schedules K-1 to the partners by March 15, 2017, it must have done so to qualify for relief.

This relief will be granted automatically for penalties for failure to timely file Forms 1065, 1065-B, 8804, 8805, and any other returns, such as Form 5471, for which the due date is tied to the due date of Form 1065 or Form 1065-B. Partnerships that qualify for relief and have already been assessed penalties can expect to receive a letter within the next several months notifying them that the penalties have been abated.

For reconsideration of a penalty covered by Notice 2017-47 that has not been abated by February 28, 2018, IRS advises that taxpayers should contact the number listed in the letter that notified them of the penalty or call (800) 829-1040 and state that they are entitled to relief under Notice 2017-47.

Taxpayers who qualify for relief under Notice 2017-47 will not be treated as having received a first-time abatement under the IRS's administrative penalty waiver program.

Notice 2017-42, 2017-34 IRB.

IRS intends to amend the §871(m) dividend equivalent regulations, finalized in September of 2015, to delay the effective/applicable date of certain rules in those regulations. IRS also extended by one year the delayed implementation period set out in Notice 2016-76 for certain provisions of the regulations.

In general, nonresident aliens and foreign corporations are taxed at a flat 30% (or lower treaty rate) on certain types of income, including dividends, that are U.S.-source and not "effectively connected" with a U.S. trade or business. (§871(a), §881(a)) However, according to IRS, many non-U.S. investors enter into swaps or other derivative contracts that pay "dividend equivalents," instead of directly holding the dividend-paying equities on which they are based, in order to avoid U.S. tax.

§871(m) treats a "dividend equivalent" as a dividend from sources within the U.S. for purposes of (among other Code sections) §871(a) (dealing with the tax on nonresident alien's income which is unconnected with a U.S. trade or business) and §881 (dealing with the tax on income of foreign corporations not connected with U.S.). §871(m)(2) defines a dividend equivalent as (1) any substitute dividend made pursuant to a securities lending or sale-repurchase transaction that (directly or indirectly) is contingent upon or determined by reference to the payment of a dividend from sources within the U.S., (2) any payment made pursuant to a specified notional principal contract (NPC) that (directly or indirectly) is contingent upon or determined by reference to the payment of a dividend from sources within the U.S., or (3) any other payment that IRS determines is "substantially similar" to a specified NPC payment or substitute dividend payment.

An NPC is a financial instrument that provides for payments by one party to another at specified intervals calculated by reference to a "specified index" upon a "notional principal amount" in exchange for specified consideration or a promise to pay similar amounts. NPCs include interest rate swaps, currency swaps, basis swaps, interest rate caps and floors, commodity swaps, equity swaps, equity index swaps, and similar agreements.

IRS issued final regulations in 2013 with respect to dividend equivalents, then issued final, temporary, and proposed regulations in September 2015, with correcting amendments on December 7, 2015. The final §871(m) regulations were to be effective, with exceptions, on September 28, 2015, with certain provisions concerning specified NPCs and equity-linked instruments (ELIs) applying to any payment made on or after January 1, 2017, with respect to any transaction issued on or after that date.

On December 19, 2016, IRS issued Notice 2016-76, which provided for the phased-in application of certain provisions of the §871(m) regulations in light of expected amendments to the §871(m) regulations and taxpayers' concerns about complying with certain aspects of the regulations by the January 1, 2017 applicability date. Those challenges included designing, building, and testing new withholding and reporting infrastructure for dealers, issuers, and other withholding agents; implementing new system requirements for paying agents and clearing organizations; and enhancing and developing data sources for determining whether transactions are §871(m) transactions. In addition, certain taxpayers may face additional challenges applying for status as a qualified derivatives dealer (QDD) under the QI agreement (the 2017 version of which was published as part of Revenue Procedure 2017-15, 2017-3 IRB 437, which included requirements and obligations applicable to QDDs; and implementing the QDD regime in a timely manner.

IRS issued final and temporary regulations on January 24, 2017, which finalized the 2015 proposed regulations, with certain modifications, and reflected the phased-in application described in Notice 2016-76.

In Notice 2017-42, IRS has now extended parts of the phase-in period described in both Notice 2017-76 and Revenue Procedure 2017-15 for one additional year. IRS noted that dealers, issuers, and other withholding agents have indicated that they would benefit from further time to refine their systems and to design, build, and test new withholding and reporting systems.

The extended phased-in implementation is as follows:

a. Through 2018, IRS will take into account the extent to which the taxpayer or withholding agent made a good faith effort to comply with the §871(m) regulations in enforcing the §871(m) regulations for any "delta-one" transaction.

Observation: IRS does not define a delta-one transaction. In general, a "delta-based standard" is one that measures the change in the value of an instrument relative to a change in the value of the underlying security. The delta of an NPC or an ELI is the ratio of the change in the fair market value (FMV) of the NPC or ELI to the change in the FMV of the referenced property, determined in a commercially reasonable manner. A delta of one means that for any change in the value of a derivative there is expected to be an identical change in the value of the underlying security. For more details on the delta test.

b. Through 2019, IRS will take into account the extent to which the taxpayer or withholding agent made a good faith effort to comply with the §871(m) regulations in enforcing the §871(m) regulations for any non-delta-one transaction.

c. Through 2018, withholding agents may rely on a simplified standard for determining whether transactions are combined transactions pursuant to Regulation §1.871-15(n) (i.e., when two or more potential §871(m) transactions are treated as a single transaction as to an underlying security). IRS noted that transactions that are entered into in 2017 and 2018 that are not combined under this simplified standard will not become combined transactions as a result of applying Regulation §1.871-15(n) to these transactions in future years, unless a reissuance or other event causes the transactions to be retested to determine whether they are §871(m) transactions.

d. Through 2018, IRS will take into account the extent to which a QDD made a good faith effort to comply with the §871(m) regulations and the relevant provisions of the 2017 QI Agreement. IRS further noted that it intends to revise the 2017 QI Agreement to provide that a QDD will be considered to satisfy the obligations that apply specifically to a QDD under that agreement for 2018 provided that the QDD makes a good faith effort to comply with the relevant provisions of the 2017 QI Agreement.

e. Through 2018, a QDD will not be subject to tax under §881(a)(1), or withholding under chapters 3 and 4, on dividends (including deemed dividends) and dividend equivalents received in its equity derivatives dealer capacity. However, IRS noted that a QDD will remain liable for tax under §881(a)(1) on dividends and dividend equivalents that it receives in any capacity other than as an equity derivatives dealer, and on any other U.S. source FDAP payments that it receives (whether or not in its equity derivatives dealer capacity). In addition, a QDD is responsible for withholding on dividend equivalents it pays to a foreign person on a §871(m) transaction, whether acting in its capacity as an equity derivatives dealer or otherwise.

f. A QDD will be required to compute its §871(m) amount using the net delta approach beginning in 2019 (instead of 2018).

g. Through 2018, a QDD is not required to perform a periodic review with respect to its QDD activities. Notice 2017-42 specifies that a QDD must use the same year for the periodic review of its QI activities and its QDD activities. A QI that is a QDD must choose 2019 or a later year within its periodic review period in which to perform its periodic review unless its applicable periodic review period ends in 2018 or an earlier year.

Taxpayers may rely on the provisions of Notice 2017-42 pending promulgation of the described amendments to the §871(m) regulations and the 2017 QI Agreement.

Notice 2017-36, 2017-33 IRB.

IRS intends to amend Regulation §1.385-2 -i.e., the "Documentation Regulations" that form part of the regulations issued this past October with respect to whether related party debt is treated as equity-to apply only to interests issued or deemed issued on or after January 1, 2019. This amendment has the effect of delaying the application of the Documentation Regulations by 12 months.

§385(a) authorizes IRS to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated as stock or indebtedness, or part stock and part indebtedness, for purposes of the Code. Because no final regulations are currently in effect under §385, the case law that developed before the enactment of §385 has continued to evolve and to control the characterization of an interest in a corporation as debt or equity.

On April 8, 2016, IRS published proposed regulations (Preamble to Proposed Regulation 04/04/2016) under §385 (proposed regulations) concerning the treatment of certain interests in corporations as stock or indebtedness. Included in those proposed regulations was Proposed Regulation §1.385-2, the Documentation Regulations, which provided rules for the documentation necessary to determine whether an interest in a corporation is treated as stock or indebtedness for all purposes of the Code.

The Documentation Regulations have two principal purposes. The first is to provide guidance regarding the documentation and other information that must be prepared, maintained, and provided for use in the determination of whether an instrument subject to the Documentation Regulations will be treated as indebtedness for federal tax purposes. The second is to establish certain operating rules, presumptions, and factors to be taken into account in the making of any such determination.

Under the proposed regulations, the Documentation Regulations would have applied to interests issued or deemed issued on or after the date the proposed regulations were finalized.

In October 2016, IRS issued final regulations that included final Documentation Regulations. (T.D. 9790, 10/13/2016) In response to the concern expressed by taxpayers that the proposed regulations provided inadequate time to begin complying with the Documentation Regulations, the final Documentation Regulations were made applicable only with respect to interests issued or deemed issued on or after January 1, 2018. (Regulation §1.385-1(f), Regulation §1.385-2(d)(2)(iii) and Regulation §1.385-2(i))

In response to the concern that taxpayers have continued to raise with the application of the Documentation Regulations to interests issued on or after January 1, 2018, and in light of further actions concerning the final and temporary regulations under §385 in connection with the review of those regulations, IRS has determined that these concerns warrant a delay in the application of the Documentation Regulations by 12 months.

Accordingly, IRS intends to amend the Documentation Regulations to apply only to interests issued or deemed issued on or after January 1, 2019. Pending the issuance of those regulations, taxpayers may rely on the delay in application of the Documentation Regulations set forth in the Notice.

And, IRS has requested that taxpayers submit comments concerning whether the proposed amendment and delay of the application of the Documentation Regulations affords adequate time for taxpayers to develop any necessary systems or processes to comply with the Documentation Regulations.

Notice 2017-23, 2017-16 IRB; IR 2017-70.

Interim guidance with respect to the election available to certain small businesses to offset the social security payroll tax with all or a portion of their research credit. The interim guidance includes information on the term "qualified small business" (QSBs) and information relating to the time and manner of making the election (the payroll tax credit election) and claiming the credit.

The payroll tax credit election is available to QSBs under §41(h) to claim the payroll tax credit under §3111(f). Under §41(h)(3)(A)(i), a QSB means, with respect to any tax year, a corporation or partnership if (i) the gross receipts (as determined under the rules of §448(c)(3), without regard to subparagraph (A)) of such entity for the tax year are less than $5 million, and (ii) such entity did not have gross receipts (as so determined) for any tax year preceding the 5-tax-year period ending with such tax year. In addition, under §41(h)(3)(A)(ii), a QSB includes any person (other than a corporation or partnership) who meets the requirements of §41(h)(3)(A)(i)(I) and §41(h)(3)(A)(i)(II), determined by substituting "person" for "entity" each place it appears, and by taking into account only the aggregate gross receipts received by such person in carrying on all the trades or businesses of such person.

§41(h)(2) provides that the payroll tax credit portion of the research credit with respect to any QSB for any tax year is the least of (A) the amount specified in the payroll tax credit election, (B) the research credit for the tax year (determined before the application of §41(h)), or (C) in the case of a QSB other than a partnership or S corporation, the amount of the business credit carryforward.

Under §41(h)(4)(B)(i), the amount specified in any payroll tax credit election may not exceed $250,000.

§41(h)(5)(A) provides that, except as provided in §41(h)(5)(B), all persons or entities treated as a single taxpayer under §41(f)(1) shall be treated as a single taxpayer for purposes of §41(h). For purposes of §41(h) and §3111(f), each of the persons treated collectively as a single taxpayer under §41(h)(5)(A) may separately make the payroll tax credit election for any tax year. (§41(h)(5)(B)(i)) §41(h)(5)(B)(ii) provides that the $250,000 amount is allocated among all persons treated collectively as a single taxpayer under §41(h)(5)(A).

The Notice provides the following interim guidance:

a. **Definition of gross receipts**. The term "gross receipts" means gross receipts as determined under §448(c)(3) (without regard to §448(c)(3)(A)) and Regulation §1.448-1T(f)(2)(iii) and Regulation §1.448-1T(f)(2)(iv). The definition of gross receipts under §41(c)(7) does not apply. (Notice 2017-23, §3.04)

   For purposes of the gross receipts rules, all members of a controlled group for a tax year are treated as a single taxpayer. Thus, the aggregate gross receipts of all members of a controlled group for a tax year must be taken into account in determining whether the gross receipts requirements are satisfied. (Notice 2017-23, §3.05)

b. **Time and manner of election.** A QSB makes a payroll tax credit election by completing the appropriate portion of Form 6765, Credit for Increasing Research Activities, or successor form, relating to the payroll tax credit election, and attaching the completed form to the QSB's timely filed (including extensions) return for the tax year to which the election applies. The term "return" means the return required to be filed under §6031 in the case of a partnership (for example, the Form 1065 or successor form), the return required to be filed under §6037 in the case of an S corporation (for example, the Form 1120-S or successor form), and the return with respect to income tax for the tax year in the case of any other QSB.

If a QSB timely files its return for a tax year beginning after December 31, 2015, but fails to make the payroll tax credit election, it may make the election on an amended return filed on or before December 31, 2017. To qualify for this extension, the business must either: 1) indicate on the top of its Form 6765 reflecting the payroll tax credit election that the form is "FILED PURSUANT TO Notice 2017-23," or 2) attach a statement to its Form 6765 reflecting the payroll tax credit election that the form is filed pursuant to Notice 2017-23. (Notice 2017-23, §4.02)

c. **Special rules for controlled groups**. As to the amount of the election for members of a controlled group, each member can separately elect the least of: (a) The electing member's allocable share of the group's research credit, as determined under Regulation §1.41-6T(c), (b) The electing member's allocable share of the $250,000 amount, or (c) In the case of an electing member other than a partnership or S corporation, the amount of the electing member's business credit carryforward carried from the tax year.

The $250,000 amount is allocated to each member of a controlled group in the same manner as the group's research credit is allocated under Regulation §1.41-6T(c), regardless of whether all members of the controlled group make the payroll tax credit election. Thus, the $250,000 amount is allocated to each member of a controlled group on a proportionate basis to its share of the aggregate of the qualified research expenses, basic research payments, and amounts paid or incurred to energy research consortiums (collectively referred to as QREs) taken into account for the tax year by such controlled group for purposes of the research credit. (Notice 2017-23, §4.05)

d. **Claiming the credit on the employment tax return.** A QSB that elects to claim the payroll tax credit and files quarterly employment tax returns, claims the payroll tax credit on its employment tax return for the first quarter that begins after it files the return reflecting the election For example, if a QSB files an income tax return on April 10, 2017, with a Form 6765 attached reflecting the payroll tax credit election, the QSB would claim the payroll tax credit on its Form 941, Employer's Quarterly Federal Tax Return, for the third quarter of 2017. A QSB that files annual employment tax returns claims the payroll tax credit on its annual employment tax return that includes the first quarter beginning after the date on which the business files the return reflecting the election.

A QSB claiming the payroll tax credit on its employment tax return must complete Form 8974, Qualified Small Business Payroll Tax Credit for Increasing Research Activities, or successor form, and attach the completed form to that employment tax return.

Under various employment tax procedural rules, the Employer Identification Number (EIN) of the taxpayer filing the employment tax return may differ from the EIN of the taxpayer that filed the return with an attached Form 6765 reflecting the election. On Form 8974, the taxpayer filing the employment tax return claiming the credit provides the EIN used on the Form 6765 reflecting the election.

The payroll tax credit claimed by an employer on an employment tax return cannot exceed the employer portion of the social security tax for any calendar quarter on wages paid with respect to the employment of all individuals in the employ of the employer. The employer uses Form 8974 to apply this limit to the amount of the payroll tax credit it elected on Form 6765 and to determine the amount of the credit allowed on its employment tax return. If the payroll tax credit elected on Form 6765 exceeds this limitation, then the excess determined on Form 8974 is carried over to the succeeding calendar quarter(s) and allowed as a payroll tax credit for the succeeding quarter(s), subject to the social security tax limitation applicable to the quarter(s). (Notice 2017-23, §4.06)

The Notice contains a request for comments on several subjects including: preventing the avoidance of the purposes of the limitations and aggregation rules through the use of successor companies or other means; and recapturing the benefit of payroll tax credits in cases where there is a subsequent adjustment to the payroll tax credit portion of the research credit, including requiring amended income tax returns in the cases where there is such an adjustment. (Notice 2017-23, §6)

Notice 2016-76, 2016-51 IRB.

Phased-in application of the §871(m) dividend equivalent regulations finalized in September of 2015 in light of amendments that it expects to make to the regulations and comments from taxpayers on difficulties of meeting the previous applicability date.

In general, nonresident aliens and foreign corporations are taxed at a flat 30% (or lower treaty rate) on certain types of income, including dividends, that are U.S.-source and not "effectively connected" with a U.S. trade or business. (§871(a), §881(a)) However, according to IRS, many non-U.S. investors enter into swaps or other derivative contracts that pay "dividend equivalents," instead of directly holding the dividend-paying equities on which they are based, in order to avoid U.S. tax.

§871(m) treats a "dividend equivalent" as a dividend from sources within the U.S. for purposes of (among other Code sections) §871(a) (tax on nonresident alien's income which is unconnected with a U.S. trade or business) and §881 (tax on income of foreign corporations not connected with U.S.). §871(m)(2) defines a dividend equivalent as (1) any substitute dividend made pursuant to a securities lending or sale-repurchase transaction that (directly or indirectly) is contingent upon or determined by reference to the payment of a dividend from sources within the U.S., (2) any payment made pursuant to a specified notional principal contract (NPC) that (directly or indirectly) is contingent upon or determined by reference to the payment of a dividend from sources within the U.S., or (3) any other payment that IRS determines is "substantially similar" to a specified NPC payment or substitute dividend payment. An NPC is a financial instrument that provides for payments by one party to another at specified intervals calculated by reference to a "specified index" upon a "notional principal amount" in exchange for specified consideration or a promise to pay similar amounts. NPCs include interest rate swaps, currency swaps, basis swaps, interest rate caps and floors, commodity swaps, equity swaps, equity index swaps, and similar agreements.

IRS issued final regulations in 2013 with respect to dividend equivalents, then issued final, temporary, and proposed regulations in September 2015, with correcting amendments on December 7, 2015. The regulations were to be effective, with exceptions, on September 28, 2015, with certain provisions concerning specified NPCs and equity-linked instruments (ELIs) applying to any payment made on or after January 1, 2017, with respect to any transaction issued on or after that date.

On July 1, 2016, IRS released Notice 2016-42, 2016-29 IRB 67, containing a proposed QI agreement (the proposed QI agreement) that describes requirements and obligations that will be applicable to QDDs. IRS intends to publish a final QI agreement before the end of 2016, taking into account comments received in response to Notice 2016-42, which will be effective on or after January 1, 2017.

IRS stated in Notice 2016-76 that amendments to the §871(m) regulations "are expected" and that taxpayers have raised concerns about complying with certain aspects of the regulations by their January 1, 2017 applicability date. Those challenges include designing, building, and testing new withholding and reporting infrastructure for dealers, issuers, and other withholding agents; implementing new system requirements for paying agents and clearing organizations; and enhancing and developing data sources for determining whether transactions are §871(m) transactions. In addition, certain taxpayers may face additional challenges applying for status as a qualified derivatives dealer (QDD) under the Qualified Intermediary (QI) withholding agreement (QI agreement) and implementing the QDD regime in a timely manner.

The phased-in implementation is as follows:

a. For 2017, IRS will take into account the extent to which the taxpayer or withholding agent made a good faith effort to comply with the §871(m) regulations in enforcing the §871(m) regulations for any delta-one transaction;

Observation: In general, a "delta-based standard" is one that measures the change in the value of an instrument relative to a change in the value of the underlying security. The delta of an NPC or an ELI is the ratio of the change in the fair market value (FMV) of the NPC or ELI to the change in the FMV of the referenced property, determined in a commercially reasonable manner. For more details on the delta test.

b. For 2018, IRS will take into account the extent to which the taxpayer or withholding agent made a good faith effort to comply with the §871(m) regulations in enforcing the §871(m) regulations for any non-delta-one transaction;

c. For 2017, withholding agents may rely on a simplified standard for determining whether transactions are combined transactions pursuant to Regulation §1.871-15(n);

d. For 2017, withholding agents may remit amounts withheld for dividend equivalent payments quarterly;

e. For 2017 and following years, a QDD's §871(m) amount is to be determined by calculating the net delta exposure of the QDD;

f. For 2017, IRS will take into account the extent to which the QDD made a good faith effort to comply with the QDD provisions in the QI agreement when enforcing those provisions;

g. Prospective QDDs may apply for QDD status on or before March 31, 2017, and, if accepted by IRS, be treated as having QDD status as of January 1, 2017;

h. Before receiving a QI-EIN, QDDs may provide a statement on a Form W-8IMY that the QDD is "awaiting QI-EIN," and withholding agents may rely on this statement, to the extent permitted in Notice 2016-76; and

i. The §871(m) regulations will not apply to certain existing exchange-traded notes specifically identified in Notice 2016-76, §III.D until January 1, 2020. (Notice 2016-76, §III)

The anti-abuse rule provided in Regulation §1.871-15(o) will apply during the phase-in years described in Notice 2016-76. As a result, a transaction that would not otherwise be treated as a §871(m) transaction (including as a result of Notice 2016-76), may be a §871(m) transaction under Regulation §1.871-15(o).

Under Regulation §1.1461-2(b), a withholding agent that fails to withhold on a payment made to a beneficial owner may withhold on a future payment made to the beneficial owner or may satisfy the tax from property that it holds in custody for the beneficial owner or from property over which it has control. That additional withholding or satisfaction of tax must be made no later than the due date (not including extensions) for filing Form 1042 for the year in which the underwithholding occurred.

Under IRS's interpretation of Regulation §1.1461-2(b), a withholding agent that adjusts its underwithholding pursuant to those procedures will not be subject to any penalties for failure to deposit or failure to pay under §6656, §6672, §7202 when it timely deposits the additional amounts withheld or otherwise obtained. Therefore, a withholding agent that fails to withhold on a dividend equivalent payment made to a foreign person may rely on the procedures in Regulation §1.1461-2(b) to adjust its underwithholding without penalty before March 15 of the year following the year in which the underwithholding occurred.

Notice 2016-77, 2016-52 IRB.

Reminder to taxpayers that, for low-income housing tax credit (LIHTC) purposes, a project will not qualify for the preference set out in §42(m)(1)(B)(ii)(III) unless it is both located in a qualified census tract and its development contributes to a "concerted community revitalization plan."

The LIHTC is allowed annually over a 10-year credit period beginning with the tax year a qualified low-income building is placed in service (or, if elected, the next tax year). (§42(f)) The amount of the credit for any tax year in the credit period equals the applicable percentage of the qualified basis of each "qualified low-income building." A qualified low-income building is any building that is, at all times during a statutorily prescribed period, part of a "qualified low-income housing project." (§42(c)(2))

The LIHTC for a building is limited to the housing credit dollar amount allocated to the building by a housing credit agency. (§42(h)(1)(A)) Under §42(m), every allocation of housing credit dollar amount must be made pursuant to a qualified allocation plan (QAP) that contains certain preferences and selection criteria mandated by the Code. One of the preferences is for projects in "qualified census tracts" (i.e., those designated by the Department of Housing and Urban Development that are characterized either by the percentage of households below a certain income threshold or by a poverty rate above a certain threshold), the development of which "contributes to a concerted community revitalization plan." (§42(m)(1)(B)(ii)(III))

In some cases, state or local agencies allocating housing credit dollar amounts have given preference to projects that are located in qualified census tracts without regard to whether the projects contribute to a concerted community revitalization plan. In some other cases, because development of new multifamily housing benefits a neighborhood, the development of a LIHTC project, without more, has been treated as if it were such a plan.

According to Notice 2016-77, this practice risks exacerbating concentrations of poverty, which is why a preference is given to placement of projects in qualified census tracts only where there is an added benefit to the neighborhood in the form of the project's contribution to a concerted community revitalization plan.

IRS reminded taxpayers that a project will not satisfy the description in §42(m)(1)(B)(ii)(III) unless its development contributes to a "concerted community revitalization plan." Although no guidance has been issued defining that term, the preference fails to apply unless, not later than the allocation, a plan exists that contains more components than the project itself.

IRS and the Treasury Department are considering providing guidance to clarify the preference in §42(m)(1)(B)(ii)(III) and request comments, by February 10, 2017, regarding the contents of that guidance.

Notice 2016-73, 2016-51 IRB.

IRS intends to issue regulations under §367 to modify the rules relating to the treatment of property used to acquire parent stock or securities in certain triangular reorganizations involving one or more foreign corporations, and the consequences to persons that receive parent stock or securities pursuant to that triangular reorganizations. IRS also intends to issue regulations under §367 to modify the amount of an income inclusion required in certain inbound nonrecognition transactions.

A U.S. person's transfer of appreciated property (including stock) to a foreign corporation in connection with §332, §351, §354, §356, or §361 exchanges generally is treated under §367(a)(1) as a taxable transaction, unless an exception applies. §367(b) provides that a foreign corporation is considered to be a corporation for purposes of these exchange provisions, except to the extent provided in regulations issued to prevent tax avoidance.

No gain or loss is recognized to a corporation on the receipt of money or other property in exchange for stock of that corporation. (§1032) In the case of a forward triangular merger, a triangular C reorganization, or a triangular B reorganization, a parent's stock provided by it to its subsidiary-or provided directly to a target corporation or its shareholders on the subsidiary's behalf-under a reorganization plan is treated as a disposition by the parent of shares of its own stock. (Regulation §1.1032-2(b)) However, if the subsidiary did not receive the parent's stock from the parent under a reorganization plan, it must recognize gain or loss on the exchange of its parent stock for the target's stock or assets. (Regulation §1.1032-2(c)) The subsidiary does not recognize gain or loss on the parent's stock that it exchanges for the target's stock in a reverse triangular merger. (§361)

A corporation's distribution of property to its shareholder with respect to its stock is included in the shareholder's gross income to the extent the distribution is a dividend under §316 (i.e., a distribution out of a corporation's current and accumulated earnings and profits (E&P)). (§301(c)(1)) To the extent the distribution is not a dividend, the shareholder reduces basis in the distributing corporation's stock, and any amount of the distribution in excess of the shareholder's basis is treated as gain from the sale or exchange of the corporation's stock. (§301(c)(2), §301(c)(3))

Regulation §1.367(b)-10 applies to certain triangular reorganizations in which a subsidiary (S) acquires stock or securities of its parent corporation (P) in exchange for property (the P acquisition), and S exchanges the P stock or securities so acquired for stock, securities, or property of a target corporation (T). The final regulations do not apply unless P or S (or both) is a foreign corporation. The application of the final regulations is also subject to certain exceptions, including the §367(a) priority rule. (Regulation §1.367(b)-10(a)(1))

When applicable to a triangular reorganization, the final regulations require that adjustments be made that have the effect of a distribution of property from S to P under §301 (deemed distribution). (Regulation §1.367(b)-10(b)(1)) For this purpose, the amount of the deemed distribution generally is the amount of property that was transferred by S to acquire the P stock and securities in the P acquisition. For purposes of making the required adjustments, the final regulations treat the deemed distribution as a separate transaction that occurs before the P acquisition or, if P does not control S at the time of the P acquisition, immediately after P acquires control of S, but before the triangular reorganization. (Regulation §1.367(b)-10(b)(3))

Regulation §1.367(b)-10(a)(2)(iii) provides that the final regulations do not apply to a triangular reorganization if, in an exchange under §354 or §356, one or more U.S. persons exchange stock or securities of T and the amount of gain in the T stock or securities recognized by such U.S. persons under §367(a)(1) is equal to or greater than the sum of the amount of the deemed distribution that would be treated by P as a dividend under §301(c)(1) and the amount of such deemed distribution that would be treated by P as gain from the sale or exchange of property under §301(c)(3) (together,

§367(b) income) if the final regulations otherwise would apply to the triangular reorganization (the §367(a) priority rule).

Regulation §1.367(a)-3(a)(2)(iv) provides a similar priority rule that turns off the application of §367(a)(1) to an exchange under §354 or §356 that occurs in connection with a triangular reorganization described in the final regulations if the amount of gain that otherwise would be recognized under §367(a)(1) (without regard to any exceptions) is less than the amount of the §367(b) income recognized under the final regulations (the §367(b) priority rule).

Regulation §1.367(b)-3 applies when a foreign corporation transfers assets to a domestic corporation pursuant to either a liquidation described in §332 or an asset reorganization described in §368 (in each case, an "inbound transaction"). Regulation §1.367(b)-3(a) and Notice 2016-73 refer to such foreign corporation as the "foreign acquired corporation" and such domestic corporation as the "domestic acquiring corporation." When there is an inbound transaction, in general, Regulation §1.367(b)-3 requires certain shareholders (including certain foreign corporate shareholders) of the foreign acquired corporation to include in income as a deemed dividend the "all earnings and profits amount" with respect to their stock. Under §1.367(b)-2(d), the all earnings and profits amount of a foreign acquired corporation is determined under the principles of §1248 for computing the amount of E&P attributable to stock, with certain modifications. For example, the all E&P amount does not take into account E&P of foreign subsidiaries of the foreign acquired corporation, notwithstanding §1248(c)(2). (Regulation §1.367(b)-2(d)(3)(ii))

In May of 2014, IRS issued Notice 2014-32, 2014-20 IRB 1006 (the 2014 Notice, which outlined the ways that it intended to revise the §367(b) "Killer B" final regulations. Among other things, the Notice provided that the amount of income and gain taken into account for purposes of applying the priority rules of §367(a) and §367(b) would be modified, and the application of the anti-abuse rule would be clarified.

IRS has become aware that taxpayers are engaging in various transactions designed to repatriate earnings and basis of foreign corporations without incurring U.S. tax by exploiting the §367(a) priority rule, as modified by the 2014 Notice.

In Notice 2016-73, IRS announced the modification of rules under §367 that would address certain triangular reorganizations involving foreign corporations where a subsidiary acquires its parent's stock for property and uses that stock to acquire a target corporation. The rules would also modify the "all earnings and profits amount" that must be included in income as a result of certain inbound asset acquisitions that repatriate "excess asset basis" .

IRS intends to modify:

a. The §367(a) priority rule to apply only when T is a domestic corporation. Accordingly, when T is a foreign corporation, the final regulations, as modified by Notice 2016-73, will apply to a triangular reorganization described in Regulation §1.367(b)-10(a)(1), unless an exception in Regulation §1.367(b)-10(a)(2)(i) or Regulation §1.367(b)-10(a)(2)(ii) applies. (Notice 2016-73, §4.01)

b. the §367(b) priority rule to provide that, in an exchange under §354 or §356 that occurs in connection with a transaction described in the final regulations, to the extent one or more U.S. persons exchange stock or securities of a foreign corporation for P stock or securities acquired by S in exchange for property (as defined in Regulation §1.367(b)-10(a)(3)(ii), as modified by Notice 2016-73) in the P acquisition, §367(a)(1) will not apply to such U.S. persons with respect to the exchange of the stock or securities of the foreign corporation. Instead, the exchange will be subject to Regulation §1.367(b)-4 and Regulation §1.367(b)-4T, as modified by Notice 2016-73.

The §367(b) priority rule, as modified by the 2014 Notice, will continue to apply when T is a domestic corporation. In addition, §367(a) will apply to the exchange of stock or securities of a foreign corporation to the extent such T stock or securities are exchanged for P stock or securities that are not acquired by S in exchange for property (as defined in Regulation §1.367(b)-10(a)(3)(ii), as modified by Notice 2016-73) in connection with a transaction described in Regulation §1.367(b)-10. (Notice 2016-73, §4.01)

c. Regulation §1.367(b)-4 and Regulation §1.367(b)-4T to provide that, in an exchange under §354 or §356 that occurs in connection with a transaction described in the final regulations, to the extent an exchanging shareholder exchanges stock or securities of a foreign acquired corporation for P stock or securities acquired by S in exchange for property (defined in Regulation §1.367(b)-10(a)(3)(ii), as modified by Notice 2016-73) in the P acquisition, such shareholder must: (i) include in income as a deemed dividend the §1248 amount attributable to the stock of the foreign acquired corporation that it exchanges; and (ii) after taking into account the increase in basis provided in Regulation §1.367(b)-2(e)(3)(ii) resulting from the deemed dividend (if any), recognize all realized gain with respect to the stock or securities of the foreign acquired corporation exchanged that would not otherwise be recognized. For purposes of the preceding, an exchanging shareholder is a U.S. person or foreign person that exchanges stock of a foreign acquired corporation in a prescribed exchange, regardless of whether such U.S. person is a §1248 shareholder or such foreign person is a foreign corporation in which a U.S. person is a §1248 shareholder. (Notice 2016-73, §4.02)

d. Regulation §1.367(b)-2(d)(3)(ii) to provide that, if there is excess asset basis with respect to a foreign acquired corporation, then, in the case of an exchanging shareholder to which Regulation §1.367(b)-3(b)(3) applies, the all earnings and profits amount with respect to the stock in the foreign acquired corporation that it exchanges will be increased by the specified earnings with respect to such stock (if any). If there is excess asset basis with respect to a foreign acquired corporation, as determined under Notice 2016-73, §4.03(b), a taxpayer may reduce the excess asset basis to the extent that the excess asset basis is not attributable, directly or indirectly, to property provided by a foreign subsidiary of the foreign acquired corporation. (Notice 2016-73, §4.03)

In general, excess asset basis means, with respect to a foreign acquired corporation, the amount by which the "inside asset basis" (below) of the foreign acquired corporation exceeds: (i) the E&P of the foreign acquired corporation attributable to the outstanding stock of the foreign acquired corporation; (ii) the aggregate basis in the outstanding stock of the foreign acquired corporation determined immediately before the inbound transaction and without regard to any basis increase described in Regulation §1.367(b)-2(e)(3)(ii) resulting from such inbound transaction; and (iii) the aggregate amount of liabilities of the foreign acquired corporation that are assumed by the domestic acquiring corporation in the inbound transaction determined under the principles of §357(d). Inside asset basis means, with respect to a foreign acquired corporation, the adjusted basis of the assets of the foreign acquired corporation in the hands of the domestic acquiring corporation determined immediately after the inbound transaction.

Notice 2016-73 provides that the regulations to be issued under Regulation §1.367(b)-3 will include an anti-abuse rule to address transactions engaged in with a view to avoid the purposes of the rules described in Notice 2016-73, §4.03. Under the anti-abuse rule, adjustments must be made, including by disregarding the effects of transactions, to carry out Notice 2016-73 's purpose. Thus, as one example, if a transaction is engaged in with a view to reduce excess asset basis, including by increasing the basis in the stock of the foreign acquired corporation without a corresponding increase in the basis in the assets of the foreign acquired corporation, that increase in the basis in the stock of the foreign acquired corporation will be disregarded for purposes of computing excess asset basis. (Notice 2016-73, §4.03)

Nonqualified preferred stock. §351(g)(1) provides, in relevant part, that §351(a) does not apply to a transfer of property in exchange for nonqualified preferred stock, as defined in §351(g)(2). Notice 2016-73 provides that the definition of property provided in Regulation §1.367(b)-10(a)(3)(ii) will be modified to include S stock that is nonqualified preferred stock (as defined in §351(g)(2)). (Notice 2016-73, §4.04)

The regulations described above will apply to transactions completed on or after December 2, 2016, and to any inbound transactions treated as completed before December 2, 2016 as a result of an entity classification election made under Regulation §301.7701-3 that is filed on or after December 2, 2016. No inference is intended regarding the treatment under current law of the various transactions that Notice 2016-73 is intended to address. For example, these transactions are currently subject to challenge under the anti-abuse rule.

IRS Webpage, "6-Month Extension Period for Calendar Year C Corporations" (February 8, 2017).

IRS has confirmed the accuracy of the instruction contained in the most recent draft instructions for Form 7004 (Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns) which provides a 6-month extension for 2016 and later year C corporation calendar year returns, notwithstanding §6081(b) 's 5-month extension for those returns.

Under the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (the Act), in a major restructuring of entity return due dates, effective generally for returns for tax years beginning after December 31, 2015 (i.e., beginning with 2016 tax year returns filed in 2017), C corporations have to file by the 15th day of the fourth month after the end of the tax year. Thus, C corporations using a calendar year have to file by April 15 of the following year. (§6072(a)) Under a special rule, for C corporations with fiscal years ending on June 30, this rule change will not apply until tax years beginning after December 31, 2025, and their returns are due on the 15th day of the third month after the end of the tax year. (Act §2006(a)(3))

Under the Act, effective generally for returns for tax years beginning after December 31, 2015, the 3-month automatic extension of time for corporate returns in §6081(b) was changed to an automatic 6-month extension. (This change conforms the statutory rule to the 6-month automatic extension for corporate returns in Regulation §1.6081-3(a)). However, for any return for a tax year of a C corporation which ends on December 31 and which begins before January 1, 2026, the automatic extension period is five months (not six months). And, for any return for a tax year of a C corporation which ends on June 30 and which begins before January 1, 2026, the automatic extension period is seven months (not six months). (§6081(b))

Under §6081(a), IRS may grant a reasonable extension for filing any return; such extensions are limited to six months other than in the case of taxpayers who are abroad.

IRS issued a draft of Form 7004's instructions in January 2017 and an updated draft of Form 7004 on February 1, 2017. Both contained the caption "Rev. December 2016." And, on both versions, the instructions for Form 7004 Part I, Line 1a provide, "If you are applying for an automatic 6-month extension for a calendar year C corporation with a tax year ending December 31, enter the appropriate Form Code..."

Observation: Thus, the form instructions grant a 6-month extension, while, as noted above, §6081(b) grants only a 5-month extension to calendar year C corporations.

On its webpage, IRS has confirmed the accuracy of the February 1, 2017 draft Form 7004 instructions, i.e., it has confirmed that a 6-month extension applies for 2016 and later year C corporation calendar year returns, notwithstanding §6081(b)'s 5-month extension for those returns.

IRS says that it made the webpage posting because it wants to reassure the tax professional community that the information is correct in the Form 7004 instructions regarding the automatic 6-month extension and explain that the reason it's correct is §6081(a).

IV – RETIREMENT PLANS, EMPLOYEE BENEFITS AND ESTATE PLANNING

Advocate Health Care Network v. Stapleton, (S Ct 6/5/2017) WL 2407476.

The Supreme Court has held that pension plans maintained by "principal purpose" organizations are "church plans" that are exempt from ERISA's Title I requirements.

Under ERISA §4(b)(2), church plans are exempt from ERISA's Title I requirements that apply to private employers offering pension plans.

ERISA §3(33)(A) defined a church plan as "a plan established and maintained for its employees...by a church." However, in 1980, Congress amended the definition of church plan, adding ERISA §3(33)(C)(i), which provides that "a plan established and maintained for its employees...by a church...includes a plan maintained by an organization...the principal purpose...of which is the administration or funding of [such] plan...for the employees of a church...if such organization is controlled by or associated with a church" (a "principal purpose organization").

Three church-affiliated non-profits that run hospitals and other healthcare facilities (collectively, hospitals) offered their employees defined-benefit pension plans. These plans were established by the hospitals themselves, and were managed by internal employee-benefits committees.

Current and former hospital employees filed class actions alleging that the hospitals' pension plans did not fall within ERISA's church-plan exemption because they were not established by a church.

Agreeing with the employees, the district courts held that a plan must be established by a church to qualify as a church plan.

The Third, Seventh and Ninth Circuits affirmed the district courts' decisions.

Church plan exemption covers principal-purpose organizations plans. On appeal, the Supreme Court addressed whether a church must have originally established the plans at issue in order for the plans to be exempt from ERISA's Title I requirements. The Supreme Court held that ERISA does not require that a church establish a plan in order for the church plan exemption to apply. Thus, a plan maintained by a principal purpose organization described in ERISA §3(33)(C)(i), like the hospitals, can qualify as a church plan regardless of which entity established the plan.

The Supreme Court noted that, by amending ERISA in 1980, Congress deemed the category of plans established and maintained by a church for purposes of the exemption to include plans simply maintained by principal-purpose organizations.

Rejecting the employees' argument, the majority decision reasoned that the most natural interpretation of the language added by Congress was to enable a plan maintained by a principal-purpose organizations to substitute for a plan both established and maintained by a church. The employees' argument was viewed as reading ERISA §3(33)(C)(i) as if it were missing the two words "established and."

Agreeing with the hospitals, the Supreme Court reasoned that Congress wanted to ensure that churches and church-affiliated organizations received comparable treatment under ERISA.

Observation: The Court did not rule that the hospitals involved actually were principal-purpose organizations. It remains to be seen whether these and other individual non-profit hospital systems qualify as principal-purpose organizations and otherwise meet the church plan exemption.

Observation: The Supreme Court's holding is consistent with many private letter rulings issued over the years that held that plans of church-affiliated hospitals are church plans. See, for example, PLR 200610023 and PLR 200444046.

In her concurring opinion, Justice Sotomayor agreed that the majority's decision was the correct statutory interpretation but nevertheless expressed concerns with the outcome because the relevant legislative history does not clearly endorse that result. That latter fact disturbed her because the decision to exempt plans neither established nor maintained by a church could have the kind of broad effect that is usually more thoroughly debated during a legislative session.

Justice Sotomayor noted that it was not clear that Congress would have taken the same action today with respect to some of the largest health care providers in the country. Despite their relationship to churches, organizations like the hospitals operated for-profit subsidiaries that "compete in the secular market with companies that must bear the cost of complying with ERISA."

Estate of Lillian Beckenfeld, TC Memo 2017-25.

IRS's determination to collect via levy a deceased wife's unpaid additions to tax and interest stemming from a late-filed gift tax return upheld. Her estate argued that the liability had already been paid, pointing to a check sent by the estate of her deceased husband, but the Court found that IRS properly applied that check to the husband's near-identical liability, in accordance with the clear instructions from his estate.

§6320(a)(1) and §6330(a)(1) require IRS to give a taxpayer written notice when a Federal tax lien is filed upon the taxpayer's property or when IRS intends to levy upon the taxpayer's property. The notices must inform the taxpayer of the right to request an administrative Collection Due Process (CDP) hearing in the Appeals Office. If such a hearing is timely requested, it is held before an impartial officer or employee of IRS, and the taxpayer may raise any relevant issue. (§6320(a)(3)(B), §6330(a)(3)(B))

After the administrative hearing is completed, the Appeals Office issues a written notice of determination indicating whether the notice of Federal tax lien should remain in effect and/or whether the proposed levy may proceed. (§6330(c)(3), Regulation §301.6320-1(e)(3), Q&A E8, Regulation §301.6330-1(e)(3), Q&A E8)

A taxpayer may appeal the Appeals Office determination to the Tax Court within 30 days of the determination, and if an appeal is timely filed, the Court will have jurisdiction with respect to the matter. (§6330(d)(1), Regulation §301.6330-1(f)(1))

Lillian Beckenfeld passed away on October 23, 2007. Her spouse, Mickey Beckenfeld, died on May 4, 2012. Ronald Beckenfeld is their son and the trustee of both of his parents' estates.

On August 31, 2012, Ms. Beckenfeld's estate filed late Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return (gift tax return), with respect to Ms. Beckenfeld's 2007 tax year. Ms. Beckenfeld's 2007 gift tax return showed total tax of $1.3 million. Ms. Beckenfeld's estate did not elect on the return to treat any gifts made by either Ms. or Mr. Beckenfeld as "split gifts" made one-half by each under §2513(a). A gift tax return for Mr. Beckenfeld's 2007 tax year was filed on the same date, showing the same total tax, and similarly not electing to split gifts. Payment in the amounts shown on the returns was remitted the same day.

On January 14, 2013, IRS assessed the total gift tax of $1.3 million shown on Ms. Beckenfeld's 2007 gift tax return, credited the estate's payment of that amount, and also assessed additions to tax under §6651(a)(1) and §6651(a)(2) of $298,046 and $331,163, respectively, as well as interest of $322,203 (collectively, Ms. Beckenfeld's 2007 liability). On the same day, IRS sent Notice CP 161 to Ms. Beckenfeld's estate requesting a payment of $951,412 (i.e., the total amount of additions and interest). On June 17, 2013, similar assessments were made with respect to Mr. Beckenfeld's 2007 gift tax return, with additions of $298,046 and $311,163, and interest of $316,835 (collectively, Mr. Beckenfeld's 2007 liability), for a total of $946,044 requested in Notice CP 220. At a time not established by the record, both estates retained Stephen Newstadt, an attorney, to represent them with respect to the payment requests.

On May 27, 2014, a revenue officer sent a letter to Ronald Beckenfeld as the trustee of Ms. Beckenfeld's estate stating that Ms. Beckenfeld's 2007 liability remained unpaid and demanding payment of that liability. Mr. Newstadt told the revenue officer that he believed that Ms. Beckenfeld's unpaid 2007 liability had been satisfied and sent documentation consisting of: (i) a copy of a check dated August 22, 2013 sent with a letter from Mr. Beckenfeld's estate, with Mr. Beckenfeld's Social Security number written on it, in the amount of $951,412; and (ii) a copy of a letter to IRS regarding Mr. Beckenfeld's 2007 liability, stating that the enclosed check "represents final payment pursuant to...the CP220 dated June 17, 2013."

At a February 10, 2015 telephone hearing, Mr. Newstadt argued that the August 22, 2013 check was intended to pay Ms. Beckenfeld's 2007 liability.

A notice of determination sustaining the levy notice was issued to Ms. Beckenfeld's estate on February 20, 2015.

Ms. Beckenfeld's estate acknowledged that Mr. Beckenfeld's estate's instructions to IRS were to apply the check against Mr. Beckenfeld's 2007 liability, but argued that the check was intended to pay Ms. Beckenfeld's 2007 liability.

The Court rejected this argument, citing *Dixon,* (2013) 141 TC 173, for the principle that IRS "must honor a taxpayer's designation of a voluntary tax payment." IRS used the check to satisfy Mr. Beckenfeld's 2007 liability, not Ms. Beckenfeld's, as it was clearly instructed to do. Accordingly, the Court found that Ms. Beckenfeld's 2007 liability remained unpaid and upheld IRS's determinations in the determination notice.

Cavallaro v. Commissioner, (CA 1, 11/18/2016) 118 AFTR 2d ¶2016-5517.

The Court of Appeals for the First Circuit has reversed in part a Tax Court decision that "misstated" the burden of proof in a gift tax case and improperly refused to allow the taxpayers to challenge an IRS expert's valuation report which served as the basis of their disputed tax liability. The Tax Court had reasoned that, since it rejected the taxpayers' valuations, they would be unable to prove their proper liability and it would serve "no useful purpose" to allow them to dispute the report. The Appellate Court, however, found that the taxpayers' burden was simply to show that IRS's assessment against them was erroneous, and that if the taxpayers can show that it was, the Tax Court must determine the correct amount.

§2501(a) imposes a tax on the transfer of property by gift. Where property is transferred for less than full and adequate consideration, the amount by which the value of the property exceeds the consideration constitutes a gift. (§2512) Taxable gifts include "sales, exchanges and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor." (Regulation §25.2512-8)

In general, an IRS notice of deficiency is presumed correct. (*Bull v. U.S.,* (Sup Ct 1935) 15 AFTR 1069) Thus, the taxpayer typically bears the burden of proving by a preponderance of the evidence that IRS's tax assessment is erroneous. (*Helvering v. Taylor,* (Sup Ct 1935) 14 AFTR 1194) Once a taxpayer shows that IRS's determination is invalid, he "has no further obligation to show...how much" money is owed. *(U.S. v. Rexach*, (CA 1 1973) 32 AFTR 2d 73-5338)

In some limited circumstances, however, IRS bears the burden of proving a tax deficiency. One such circumstance is when as assessment is shown to be "excessive and arbitrary" or "utterly without foundation." (*U.S. v. Janis,* (Sup Ct 1976) 38 AFTR 2d 76-5378)

In addition, the burden of proof shifts to IRS in the case of any "new matter," i.e., when IRS attempts to establish the deficiency on a basis not described in the deficiency notice. (*Shea,* (1999) 112 TC 183)

In 1979, William and Patricia Cavallaro (the parents, with Mr. Cavallaro also referred to as the father) created a company, Knight Tool Co. (Knight), that manufactured tools and machine parts. The parents ran Knight, and their three sons (the sons) worked at Knight. Knight manufactured and sold a liquid-dispensing machine (the machine). However, problems with the machines caused working capital issues within Knight. One of the sons (Ken) suggested that he and his brothers take over the production of the machines, and in 1987, the sons incorporated Camelot Systems (Camelot), a corporation created to sell machines (although they were still manufactured at Knight). At its incorporation, Camelot issued 150 shares, and each son owned 50 shares. During the meeting that effectuated the incorporation of Camelot, the father handed the Camelot minute book to Ken saying, "Take it; it's yours."

In the general course of its business, Camelot received a purchase order from a customer for a machine, and then the order was submitted to Knight to request that a machine be made. Knight did not bill Camelot for the machines until they were ready, and Camelot did not pay Knight until Camelot's customer paid Camelot, so Knight bore all of the business risk associated with the sales of machines. Contracts with outside vendors who provided parts for the machines were made directly with Knight. Camelot had no employees; any person who worked on the machines was on Knight's payroll. Most of Camelot's expenses were paid with Knight funds. Both Knight and Camelot operated out of the same office space.

Based on estate planning advice given to the parents by their accountant, the family contemplated merging Knight and Camelot in 1995. The goal of the merger was to transfer some of the parents' wealth to their sons. However, the parents also met with an attorney who determined that Camelot owned the machines' technology (the technology), and not Knight, as the accountants believed, because the technology was transferred in 1987 when Camelot was incorporated. There was no paperwork that documented this transfer, but based on the father handing the minute book of Camelot to Ken, the attorney thought there was a ceremonial and symbolic transfer of the technology. Initially, the accountants disagreed with the attorney, but they were eventually convinced that the value of the technology, from its creation and including all improvements made to it up until the proposed merger, was in the hands of Camelot (and therefore in the hands of the sons, and not the parents). The parents signed a "Confirmation Bill of Sale" which confirmed the 1987 transfer of the technology from Knight to Camelot, and attempted to document that the value of the technology resided solely in Camelot. The parties decided at that time that a merger of Knight and Camelot was unnecessary because the majority of the value that the parents were concerned about from an estate tax perspective was already in the hands of their sons.

However, for unrelated reasons, the merger of Knight and Camelot did eventually come to pass. On December 31, 1995, the two companies combined in a tax-free merger, with Camelot as the surviving corporation. The stock was distributed 19% to the parents and 81% to the sons, based on the accountant's valuation of the combined entity and the separate companies. In making his valuations, the accountant assumed that Camelot owned the technology and that Knight was a contractor for Camelot. (A second valuation obtained by the parents was premised on the same ownership assumption.)

Seven months later, Camelot was purchased by a third party for $57 million in cash. On the basis of stock ownership, the parents received $10.8 million, and each son received $15.4 million.

IRS issued notices of deficiency to the parents for tax year 1995. IRS determined, without first having obtained an appraisal, that Knight had been undervalued in the merger and that Camelot had a pre-merger value of $0. Thus, it found that when Knight merged with Camelot, the parents each made a taxable gift of $23 million to their sons, which meant that each incurred an increase in tax liability of $12.7 million, plus penalties for failure to file and fraud.

The parents filed a petition for review with the Tax Court. During discovery, IRS disclosed that, after the notices of deficiency were issued, it obtained an appraisal of both Knight and Camelot at the time of the merger. Working under the assumption that Knight rather than Camelot owned the technology, the combined entities were valued at approximately $64.5 million, and Camelot was worth $22.6 million-resulting in lower deficiencies than originally asserted (combined deficiency of $29.6 million).

The parents argued that Camelot owned all of the value of the technology and possessed the majority of the value of the merged company, and that no gift was made during the merger because the shares they received in the merged company accurately reflected the value of Knight. They contended that Camelot was the manufacturer of the machines, and Knight was the contractor, and their experts argued that Camelot owned the technology because it was transferred to Camelot in 1987.

On the other hand, IRS contended that, because corporate documents showed that Knight was the manufacturer and Camelot was merely the seller (and the parents presented no evidence that showed otherwise), Knight was the owner of the technology, not Camelot, and thus Knight deserved a greater fair market value (FMV) than Camelot. Using a discounted cash flow method of valuation, IRS's expert found that Knight accounted for 65% of the merged company and Camelot accounted for 35%. This calculation resulted in a gift tax liability of $29.6 million for the additional value the parents transferred to their sons.

To determine whether the parents made taxable gifts to their sons through the merger of Knight and Camelot, first the Tax Court had to determine the FMV of the merged company, and the FMVs of Knight and Camelot on the eve of the merger.

The Tax Court determined that the merger was not at arm's length and was not made in the ordinary course of business. The Court found that any other, unrelated, purchaser of Camelot would have demanded proof of ownership of the technology. Because no proof existed, it is unlikely that an arm's length purchaser would have paid the amount that the parents exchanged in the merger. The fact that the parents overlooked that Knight really owned the technology, and thus possessed most of the value, coupled with the fact that the parents' estate planning desires consisted of the best way to convey their wealth to their sons, led the Tax Court to determine that the merger and resulting exchange of shares was not an arm's length transaction.

In valuing the pre-merger companies, the Tax Court disregarded the parents' experts because their valuations were based on Camelot owning the technology. The parents failed to present any evidence that Camelot was the rightful owner of the majority of the merged company. Because Knight had been so undervalued (because its ownership of the technology was mistakenly attributed to

Camelot), the parents should have received more shares of the merged company. Therefore, they gave their sons a tax-free gift when they received fewer shares than they were entitled to receive in the merger.

The Tax Court found that the Camelot shares that the parents received in exchange for their Knight shares were not for full and adequate consideration, and it agreed with IRS's determination-based on the IRS expert's valuations, despite the fact that such contained "arguably flawed analysis"-that the parents were liable for $29.6 million in gift tax for gifts made to their sons in the merger.

The parents appealed the Tax Court decision, renewing their claim that the Tax Court erred by failing to shift the burden of proof to IRS because the original notices of deficiency were arbitrary and excessive, and/or because IRS relied on a new theory of liability. They also claimed that the Tax Court improperly concluded that Knight owned all of the technology and that the Tax Court erred by misstating their burden of proof and subsequently failing to consider alleged flaws in the IRS expert's valuation of the two companies.

The Court of Appeals for the First Circuit upheld much of the Tax Court's decision, but reversed and remanded with regard to the "nature" of the parents' burden of proof and the Tax Court's failure to allow them to rebut the IRS expert's report.

The Court of Appeals first agreed with the Tax Court that the burden of proving the deficiency notices wrong properly remained with the parents because the original deficiency notices were not arbitrary and excessive. Although IRS later conceded a portion of the original deficiency after obtaining valuations of the companies, such was insufficient to shift the burden.

In addition, the Court found that the parents were not entitled to shift the burden of proof on the basis of IRS raising a "new matter." Although changing in degree, IRS's theory-that Knight was undervalued-remained consistent throughout.

The Tax Court's conclusion that Knight owned the technology was also upheld. The Appellate Court found no error in the Tax Court's analysis and found that no argument was advanced on appeal that would warrant overturning the Court's finding.

However, the First Circuit found merit in the parents' challenge to the IRS expert's valuation and the Tax Court's handling of their objections to it. The Appellate Court determined that, while the Tax Court did not "misallocate" the burden of proof, it did misstate "the content of that burden." IRS's deficiency notices were presumed correct, as the Tax Court noted, and the burden on the taxpayer was to show that the deficiency notice was erroneous. However, in this case, the Tax Court stated that the parents had the burden to show "the proper amount of their tax liability" and could not do so because their valuations were premised on Camelot owning the technology. The Tax Court then adopted the IRS expert's valuation in full, in spite of concerns about potential flaws, and refused to hear the parents' criticisms of the valuation because they would not be able to prove the right amount regardless.

Accordingly, the First Circuit reversed and remanded the Tax Court's decision considering the parents' burden of proof as to the valuation. The Appellate Court said that the parents should have had the opportunity to rebut the valuation report and that, if they succeed in doing so, the Tax Court must decide the correct amount. It also stated that a new expert valuation may be taken into evidence on remand.

Community Education Foundation, TC Memo 2016-223.

IRS properly revoked an organization's tax-exempt status, finding that the organization failed to satisfy the operational test under §501(c)(3) because it did not engage in any activity that accomplished one or more of the specified exempt purposes.

To qualify for tax exemption under §501(c)(3), an organization must be organized and operated exclusively for religious, charitable, scientific, or educational purposes. In addition, no part of its net earnings may inure to the benefit of any private shareholder or individual, no substantial part of its activities may include attempts to influence legislation, and the organization may not intervene in political campaigns.

One of the elements required to pass the operational test is that it engage primarily in activities that accomplish its exempt purpose. Activities that do not further exempt purposes must be an insubstantial part of the exempt organization's activities. (Regulation §1.501(c)(3)-1(c)(1)) An organization is not operated exclusively for exempt purposes unless it serves a public rather than a private interest. (Regulation §1.501(c)(3)-1(d)(1)(ii))

For the operational test to be met, (1) the organization must engage primarily in activities which accomplish one or more of the exempt purposes specified in §501(c)(3), (2) its net earnings cannot inure to the benefit of private shareholders or individuals, and (3) it must not expend a substantial part of its resources attempting to influence legislation or political campaigns. (Regulation §1.501(c)(3)-1(c)) The courts have imposed a fourth element, namely that organizations seeking exemption from taxes must serve a valid purpose and confer a public benefit.

The taxpayer (Foundation) was incorporated as ABF Educational Foundation, Inc., but has operated under the names Congressional Education Foundation, Congressional Education Foundation for Public Policy, and most recently Community Education Foundation.

On June 27, 2001, Foundation's sole officer, director, and representative Mr. Hayes submitted Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code. On the application, Mr. Hayes stated that the taxpayer was a conservative research and educational institute focusing on public policy issues that have particular impact on African Americans, Hispanic Americans, Asian Americans, Native Americans, and heritage groups (the Target Groups). The Foundation's guiding principle was to encourage open inquiry about public policy issues that are of particular interest and educational value for the Target Groups and the public in general and to provide programs that highlight and educate the Target Groups and the public about these germane subjects and/or public policy issues.

To achieve this goal, the Foundation was to undertake a variety of activities, including:

1. **Town hall meetings:** The Foundation was to sponsor a minimum of 20 town hall meetings on university campuses across the U.S. to the general public, particularly minorities in the education profession, health care profession and legal profession, business and civic leaders, religious leaders, labor union members, and college students. Each town hall meeting will discuss the reformation of tax, education, social security, health care, racial profiling, business and economic development. This activity was to account for roughly 25% of the Foundation's resources and time in any given year.

2. **National workshops**: The Foundation was to sponsor 20 national workshops in high school auditoriums, college campuses, convention centers, church auditoriums and hotels across the U.S. This activity was to account for roughly 55% of the Foundation's resources and time in any given year.

3. **Congressional forums:** The Foundation was to sponsor quarterly educational forums for public officials, non-profits, opinion pollsters, business leaders and the media to better understand minorities and their perception on certain public policy initiatives that impact their daily lives. This activity was to account for roughly 10% of the Foundation's resources and time in any given year.

4. **Media/Communication**: As part of the Foundation's efforts to raise awareness and understanding of the conservative public policy initiatives to the minorities and the general public, the Foundation was to communicate these policy initiatives across the country via billboards, radio, televisions, etc. This activity was to account for roughly 10% of the Foundation's resources and time in any given year.

On July 23, 2001, IRS granted Foundation tax-exempt status under §501(c)(3) and private foundation status under §509(a)(1) and §170(b)(1)(A)(vi).

However, Foundation did not, over time, meaningfully organize or allocate resources to any of the four enumerated activities.

On September 21, 2012, IRS issued to Foundation a letter proposing to revoke its tax-exempt status, based, in part, on its failure to establish that it met the operational test requirements under §501(c)(3). In its final adverse determination revoking Foundation's exempt status, IRS also stated that Foundation failed to establish that it was operated exclusively for exempt purposes under §501(c)(3) and Regulation §1.501(c)(3)-1(d), and failed to maintain or produce any books or records setting forth its revenue, expenses, assets, and activities or programs.

In its protest in response, Foundation admitted that it was inactive from September of 2001 through December of 2008, but it asserted that it tried, but failed, to host various events in 2009 and 2010. According to Foundation, it attempted to organize a "Presidential Inaugural Ball" to honor veterans in 2009, as well as a series of town hall meetings and benefit concerts in 2010 generally oriented towards veterans.

The Tax Court held that regardless of the applicable standard of review, IRS properly revoked the taxpayer's tax-exempt status effective January 1, 2008, because it was not operated exclusively for an exempt purpose.

The Court focused on Foundation's exempt purpose and the activities that it engaged in with respect to that purpose-or as the Tax Court emphasized, the activities that Foundation failed to engage in. According to its application, Foundation intended to further its exempt purpose by organizing monthly town hall meetings, 20 annual national workshops, and quarterly congressional forums in addition to a nationwide media campaign. While Foundation's time and resources were to be allocated 25% to town hall meetings, 55% to national workshops, 10% to congressional forums, and 10% to its nationwide media campaign, the Tax Court found that Foundation did not over time meaningfully organize or allocate resources to any of these activities.

Foundation admitted that it was inactive from September of 2001 through December of 2008 but contended that it tried to host events in 2009 and 2010 that for various reasons never occurred. Accordingly, on the basis of the record before it, the Tax Court concluded that Foundation failed to satisfy the operational test because it did not engage in any activity that accomplished one or more of the exempt purposes in §501(c)(3).

The Court did not address the other grounds on which IRS revoked the taxpayer's exempt status, noting that the issue of why certain events contemplated by the taxpayer did not materialize was not relevant to its conclusion.

DNA Pro Ventures, Inc. Employee Stock Ownership Plan v. Commissioner, (CA 8 05/09/2017) 119 AFTR 2d ¶2017-743.

The Court of Appeals for the Eighth Circuit, affirming the Tax Court, has upheld IRS's disqualification of an employee stock ownership plan (ESOP), finding that the plan's allocation of stock to a corporate officer's account exceeded the contribution limits under §401(a)(16) because the officer did not receive any compensation from the corporation that year.

ESOPs are qualified defined contribution plans which are designed to invest primarily in securities of the corporate employer and are subject to the requirements set out in §401(a). ESOPs provide corporate employers and their employees the tax benefits of a qualified plan and, in addition, provide a financing vehicle for the corporation through their ability to borrow to acquire employer securities.

In general, to be tax-qualified, a plan must meet the requirements of §401(a) in both form and operation-meaning that the plan document must contain the requisite language or terms and that the plan must actually operate in accordance with the document and otherwise satisfy §401(a).

Under §401(a)(16), a trust is not qualified if the related plan "provides for benefits or contributions which exceed the limitations of §415 " (for 2008, the lesser of $40,000 or 100% of the participant's compensation). A §415 failure is a continuing failure that disqualifies the plan for a future year even when there is not a separate, independent §415 failure in the future year.

Daniel Prohaska is an orthopedic surgeon who, during the 2008-2010 tax years, was employed by Advanced Orthopedics, P.A., and deferred the maximum income allowable to its 401(k) retirement plan. In 2008, Dr. Prohaska became involved with DNA Pro Ventures, Inc. (DNA), which was incorporated on November 12, 2008. On that date, DNA issued 50 shares of class A common stock each to Dr. Prohaska and his wife in exchange for $500. At the time of DNA's incorporation, Dr. and Mrs. Prohaska were DNA's directors and its only employees, with Dr. Prohaska acting as chairman, president and treasurer, and Mrs. Prohaska serving as vice president and secretary.

On December 31, 2008, DNA issued 1,150 shares of class B common stock to the ESOP's trust with a par value of $10 per share. The trust then allocated the 1,150 shares of DNA stock to Dr. Prohaska's ESOP account that day. DNA did not pay any salaries, wages, or other officer's compensation during 2008.

In 2011, IRS began an examination of the DNA ESOP. At several times during the course of its investigation, IRS sought documentation from DNA about the ESOP, which DNA failed to provide.

On June 6, 2014, IRS issued a final nonqualification letter to DNA explaining that the ESOP had failed to follow the terms set out in the plan documents and therefore the ESOP was not qualified under §401(a) for plan years ending December 31, 2008, 2009, and 2010. DNA transferred class B stock into the ESOP in 2008, the value of which substantially exceeded 100% of each of Dr. and Mrs. Prohaska's compensation (i.e., zero) from DNA for the year 2008. Thus, the ESOP had failed to comply with §401(a)(16) for the plan year.

The Tax Court, deciding the case on a stipulated record, found that since neither Dr. Prohaska nor Mrs. Prohaska had any compensation for services as a DNA officer or employee during 2008, their contribution limits with respect to the DNA ESOP were zero. Because DNA improperly transferred 1,150 shares of DNA's class B common stock to Dr. Prohaska's ESOP account in 2008, the annual addition to his account was $11,500 (1,150 shares at $10 each) more than his contribution limit under §415(c). Accordingly, the ESOP failed to meet the requirements of §401(a)(16) and was not a qualified plan for 2008, and because the §415 failure was a continuing failure, the ESOP also was not a §401(a) qualified plan for all subsequent plan years.

The Court of Appeals for the Eighth Circuit also agreed with IRS and thus affirmed the Tax Court.

The ESOP argued on appeal that the Tax Court "got the facts wrong." According to the ESOP, it purchased the shares from DNA on the day of its incorporation with a loan, so the Tax Court thus erred in upholding disqualification for a violation of the §415 contribution limit. The Eighth Circuit, however, found this contention unsupported by, and contrary to, the stipulated record. The Eighth Circuit also rejected the ESOP's attempt to rely on documents that were not part of the stipulated record, noting that such could not be considered on appeal. (*Anuforo v. Commissioner,* (CA 8 2010) 106 AFTR 2d 2010-5596) The Eighth Circuit further noted that the ESOP did not refute the facts that were part of the stipulated record or otherwise seek to have them re-determined by the Tax Court in an evidentiary hearing or trial.

The Appellate Court found that the stipulated record established that DNA's 2008 contribution to Dr. Prohaska's ESOP account exceeded the contribution limits, that such meant that the ESOP was not a qualified plan, and that no corrective action had been taken to remedy the disqualification. Accordingly, the Eighth Circuit found that IRS, and the Tax Court, correctly held that the ESOP was disqualified for 2008 and subsequent plan years.

Fiscalini, TC Memo 2017-163.

Taxpayer's sale of his residence to his parents was in part a sale and in part a gift. Additionally, it held that his basis in the home, which he had purchased together with his parents, included the parents' interest that they gifted to him after the purchase. Because the taxpayer failed to timely file a return for the year of sale, and did not report the sale, the taxpayer owed a §6651(a)(1) failure-to-file penalty, and a §6662(a) accuracy-related penalty.

Under Regulation §1.1001-1(e)(1), where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized exceeds the transferor's adjusted basis in the property.

Under §1001(b), the amount realized from the sale of property is the sum of any money received plus the fair market value of property other than money that is received. And, in general, the amount realized from the sale of property includes the amount of liabilities from which the transferor is discharged as a result of the sale. (Regulation §1.1001-2(a)(1))

Under §1012(a), the basis of property generally is its cost, and under §1015(a), the basis of property acquired by gift generally is the same as it would be in the hands of the donor.

Under §121, a taxpayer can exclude from income up to $250,000 of gain (up to $500,000 for joint filers) from the sale of a home owned and used by the taxpayer as a principal residence for at least two of the five years before the sale.

In 1993, Robert Fiscalini and his parents bought a home for $274,312. He paid $234,312 which he raised via a mortgage, and his parents paid $40,000 cash. Fiscalini used the home as his residence and added a swimming pool using equipment from his construction business. He also converted a detached garage into a game room. In 2003, the parents transferred their interest in the home to Fiscalini; he did not give them cash or property for that interest.

Fiscalini refinanced the home several times and in 2007, he fell behind on the mortgage payments. To avoid foreclosure, Fiscalini sold the home to his parents for $975,000, who used borrowed funds to pay off the $664,048 balance of the mortgage loans on the property. The closing statement showed that the total consideration was $975,000 and that Fiscalini was making a gift of equity to his parents of $295,655. The buyer's closing statement also showed that Fiscalini incurred settlement charges totaling $16,751. For 2007, a title company issued Fiscalini, as transferor of the property, a Form 1099-S, Proceeds From Real Estate Transactions, showing gross proceeds of $975,000 and that "Property or Services [Were] Not Received".

Fiscalini failed to file a timely return for 2007 because he was unable to pay the tax for that year. In 2013, when he finally filed a return for the 2007 tax year, he did not report any gain from the sale of his residence. IRS said he owed tax on the gain from the sale of his home, and also was liable for the §6651(a)(1) failure-to-file penalty, and the §6662(a) accuracy-related penalty.

Before the Tax Court, the principal issues were (1) the basis of Fiscalini's residence; and (2) the amount realized from the sale of the residence.

Fiscalini argued that his basis in the home should include his parents' $40,000 interest in the home that they gifted to him in 2003. IRS disagreed, advancing a vague argument that co-owners of an asset only have a cost basis in the amount each has paid for the asset.

The Tax Court rejected IRS's argument, pointing out that Fiscalini did not give his parents any cash or other property in return for their interest in the home when they transferred that interest to him in 2003. In other words, the Fiscalinis made a gift of their interest in that property to petitioner. Thus, under §1015(a), Fiscalini's basis was equal to the sum of his cost basis of $234,312 in the interest in that property that he purchased in 1993 and his basis of $40,000 in his parents' interest in that property which they gave to him in 2003, or $274,312.

Fiscalini argued that his basis also should be increased by $50,000 for costs incurred in adding a swimming pool to the residence and conversion of its garage into a game room. Tax Court rejected his argument since he all he offered in support of the claimed costs was self-serving, uncorroborated, and general testimony.

IRS's argued that the total consideration of $975,000 shown in the closing statements controlled the determination of the amount realized from the sale. However, the Tax Court pointed out that IRS disregarded the fact that Fiscalini's sale of the home to his parents was a transfer of property that was in part a sale and in part a gift.

The Tax Court held that the amount realized, before settlement costs, from the sale of the home was $664,048, the total amount of the two mortgage loans on the property at the time of the sale and that Fiscalini's parents discharged. After taking into account Fiscalini's settlement costs of $16,751, the Tax Court said the amount realized was $647,297 and the capital gain realized was $372,585. (There appears to be a slight discrepancy in the figures: the amount realized of $674,297 less the basis of $274,312 yields a gain of $372,985.) The Tax Court said that subtracting the $250,000 home sale exclusion under §121 left a long-term capital gain of $122,585 (once again there appears to be a slight discrepancy in the figures).

The Tax Court upheld IRS's determination that Fiscalini owed a §6651(a)(1) failure-to-file penalty, and a §6662(a) accuracy-related penalty.

Freedom Path, Inc. v. IRS, et al., (DC TX 7/07/2017) 120 AFTR 2d ¶ 2017-5032.

A district court, denying a motion for partial summary judgment, has concluded that the "facts and circumstances" test of Revenue Ruling 2004-6, was not unconstitutional on its face. The test is used by IRS to determine whether an organization that is otherwise exempt from federal income tax has made expenditures that subject the organization to income tax under §527(f) and whether certain applicants for tax-exempt status qualify.

Civic leagues and organizations not organized for profit but operated exclusively for the promotion of social welfare (i.e., social welfare organizations) are exempted from income tax under §501(c)(4). An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. (Regulation §1.501(c)(4)-1(a)(2)(i)) Policy issue advocacy, such as by mailings and television advertisements, is considered legitimate social welfare activity. However, the promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office. (Regulation §1.501(c)(4)-1(a)(2)(ii))

If a §501(c)(4) tax-exempt organization makes for an "exempt function," it may be subject to income tax under §527(f). The term "exempt function" refers to the function of influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any federal, state, or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors, i.e., political campaign intervention activity. (§527(e)(2)) A §501(c)(4) social welfare group that engages in political campaign intervention is subject to taxation on the amount expended for that activity (or on the group's investment income for the year, whichever is less). (§527(f)(1))

A social welfare group may, however, maintain a segregated fund for political campaign intervention activities. (§527(f)(3))

IRS uses the "facts and circumstances" test of Revenue Ruling 2004-6, 2004-4 IRB 328, to determine whether an otherwise exempt group has spent money on an "exempt function," thereby subjecting the group's income to tax under §527(f). IRS also relies on the test to determine whether applicants for tax-exempt status under §501(c)(4) qualify for such status-i.e., whether an applicant's activity is "primarily" social welfare or is inordinately dedicated to political campaign intervention.

Factors that tend to show that an advocacy communication on a public policy issue is for an exempt function include, but are not limited to:

a. The communication identifies a candidate for public office;
b. The timing of the communication coincides with an electoral campaign;
c. The communication targets voters in a particular election;
d. The communication identifies that candidate's position on the public policy issue that is the subject of the communication;
e. The position of the candidate on the public policy issue has been raised as distinguishing the candidate from others in the campaign, either in the communication itself or in other public communications; and
f. The communication is not part of an ongoing series of substantially similar advocacy communications by the organization on the same issue.

Factors that tend to show that an advocacy communication on a public policy issue is not for an exempt function include, but are not limited to:

a. The absence of any one or more of the factors listed above;

b. The communication identifies specific legislation, or a specific event outside the control of the organization, that the organization hopes to influence;
c. The timing of the communication coincides with a specific event outside the control of the organization that the organization hopes to influence, such as a legislative vote or other major legislative action (for example, a hearing before a legislative committee on the issue that is the subject of the communication);
d. The communication identifies the candidate solely as a government official who is in a position to act on the public policy issue in connection with the specific event (such as a legislator who is eligible to vote on the legislation); and
e. The communication identifies the candidate solely in the list of key or principal sponsors of the legislation that is the subject of the communication. (Revenue Ruling 2004-6, 2004-4 IRB 328)

In March of 2011, Freedom Path applied for recognition as a social welfare group under §501(c)(4). In September of 2013, IRS sent Freedom Path a "proposed denial" of its application. Using the "facts and circumstances" test to analyze Freedom Path's television advertisements and mailers, IRS concluded that many of its communications were political campaign interventions and that it was not being operated exclusively for the promotion of social welfare.

In 2014, Freedom Path sued alleging IRS had targeted it for unconstitutional and unlawful treatment based on its conservative political views. It alleged that IRS delayed its application, wrongly subjected it to burdensome requests for information, and leaked its confidential tax information. Freedom Path moved for partial summary judgment on the basis that the "facts and circumstances" test was: (a) unconstitutionally vague, in violation of the Due Process Clause of the Fifth Amendment; and (b) unconstitutionally vague and/or overbroad and promoted viewpoint discrimination (i.e., targeted the ideology, opinion, or perspective of the speaker), in violation of the First Amendment.

Freedom Path maintained that the test allowed IRS to keep disfavored §501(c)(4) groups in doubt about their continued existence by maintaining ambiguity in the standard that governs when issue advocacy becomes campaign intervention. It also argued that the test jeopardized its funding because some potential donors were prohibited by other regulations from donating to a §501(c)(4) group whose future status was in jeopardy.

The district court concluded that Freedom Path failed to show that the "facts and circumstances" test was facially unconstitutional under the First or Fifth Amendment. The court rejected Freedom Path's contention that the test was unconstitutionally vague because it failed to provide a person of ordinary intelligence with fair notice of what was prohibited and was so standardless that it leads to discriminatory enforcement.

The district court determined that the specific and objective factors set out in the test, viewed under the appropriate vagueness standard for a civil regulation (that is, subject to a less strict vagueness standard than for a criminal law) were not unconstitutionally vague. The court reasoned that the 11 non-exclusive factors in Revenue Ruling 2004-6 primarily addressed who, what, where, when, why, or how types of questions about the contents of communications-in other words, questions of the type that would be addressed in the lead of a competently written newspaper article about the organization's communications. The court found that the use of a multi-factor test did not make a tax rule vague per se. Additionally, the court found that Revenue Ruling 2004-6 was not subject to a heightened vagueness standard by virtue of being a restriction on speech.

The district court concluded that the "facts and circumstances" test did not violate the First Amendment. Although Freedom Path correctly cited precedent that prohibited the use of multi-factor tests when deciding whether speech would be punished, Revenue Ruling 2004-6 did not ban, restrain, or punish speech. Instead, it regulated whether expenditures for certain types of speech would be subsidized through their treatment for federal income tax purposes. The authorities on which Freedom Path relied held that an "open-ended rough-and-tumble of factors" may not constitutionally be used to distinguish issue advertisements from campaign speech for purposes of criminal punishment. (*Citizens United v. Federal Election Commission,* (S Ct 2010) 558 U.S. 310, 336; *Federal Election Commission v. Wisconsin Right to Life, Inc.,* (S Ct 2007) 551 U.S. 449) However, these authorities did not address the type of test that was constitutionally required when deciding an organization's eligibility for exemption from federal income tax.

The court noted that a legislature's decision not to subsidize the exercise of a fundamental right did not infringe the right, and thus was not subject to strict scrutiny. Revenue Ruling 2004-6 implemented Congress's choice to subsidize social welfare groups' issue advocacy, but not their political campaigning (unless it was done through a segregated fund). The statutory policy itself was clearly constitutional.

The Supreme Court has held that, in general, denial of a tax deduction does not infringe the right to free speech. (*Regan v. Taxation With Representation,* (S Ct 1983) 51 AFTR 2d 83-1294) The facial challenge to Revenue Ruling 2004-6 did not identify a constitutional defect.

While Freedom Path alleged that the "facts and circumstances" test did a poor job of administering the statute because its campaign speech definition was over-inclusive, even if this was true, the court found that no cited authority held that an over-inclusive tax rule affecting speech equated to an overbroad restriction on speech. The court also determined that the test's consideration of timing and other contextual factors was only an argument related to its alleged overbreadth, not an independent constitutional defect. And while a tax deduction policy that discriminated on its face against a suspect classification may violate First Amendment rights that was not alleged to be the case here.

Relying on decisions which addressed penalties on speech rather than the eligibility for exemption from federal income tax, Freedom Path failed to show that Revenue Ruling 2004-6 contributed to viewpoint discrimination. Revenue Ruling 2004-6 did not on its face single out any viewpoint or inquire into a group's intent.

Frias, TC Memo 2017-139.

A 401(k) plan loan taken out by a taxpayer before she went on leave was a taxable plan distribution subject to the premature withdrawal penalty because she failed to begin making repayments as required by the loan agreement and her repayments were not made in substantially level amounts. It did not matter that the taxpayer's employer disregarded her instructions and failed to deduct loan payments from her pay during the leave period, or that she eventually did repay the loan. However, the Tax Court declined to apply the §6662 accuracy-related penalty because she had reasonable cause for her mistake.

Under §72(p)(1)(A), any amount taken as a loan from a qualified employer plan will generally be treated as a distribution to the participant. However, under §72(p)(2), a loan will not be treated as a distribution if the loan:

1. Does not exceed the lesser of: (i) $50,000, or (ii) ½ of the present value of the employee's nonforfeitable accrued benefit under the plan. However, a loan up to $10,000 is allowed, even if it's more than half the employee's accrued benefit; (§72(p)(2)(A)

2. The loan is required to be repaid within five years, (§72(p)(2)(B)(i)) except that a longer repayment can be used for a principal residence plan loan; (§72(p)(2)(B)(ii)) and

3. Except as provided in the regulations, the plan loan is amortized in substantially level payments, made not less frequently than quarterly. (§72(p)(2)(C)) This "substantially level amortization" requirement has been interpreted as requiring that payment of principal and interest be made in substantially level amounts over the term of the loan. (*Plotkin,* TC Memo 2001-71)

A plan administrator may allow a cure (grace) period, which cannot continue beyond the last day of the calendar quarter following the calendar quarter in which the required installment payment was due, and §72(p)(2) will not be considered to have been violated if the installment payment is made not later than the end of the cure period. Where there is a failure to pay, the amount of the deemed distribution equals the entire outstanding balance of the loan (including accrued interest) at the time of the failure. (Regulation §1.72(p)-1, Q&A-10)

Under Regulation §1.72(p)-1, Q&A-9(a), a participant is exempt from the substantially level amortization requirement when he or she is on a bona fide leave of absence for no longer than a year either without pay or at a rate of pay less than the required installment payments.

Under §72(t)(1), there's a 10% additional tax on early distributions from qualified retirement plans, unless one of the specific exceptions in §72(t)(2) applies (e.g., distributions after age 59-1/2, death, or disability).

Louelia Salomon Frias took a leave of absence from her job at a nursing home when she was expecting her third child. She began her leave on July 30, 2012, and returned to work on October 12, 2012. Frias used accrued sick, personal, and vacation leave to cover about five weeks of her leave and took the rest as unpaid.

On July 27, 2012, Frias entered into a loan agreement with her 401(k) plan administrator to borrow $40,000 from her plan account, and also entered into a loan repayment payroll deduction agreement. The loan agreement required biweekly payroll deductions of $341.79 to start on the first billing statement after August 12, 2012, and, if a payment was missed, allowed Frias to pay the delinquent amounts up to the last day of the calendar month following the calendar month that the delinquent payment was due. If Frias became delinquent and did not pay the delinquent amounts within that period, then the entire loan amount would be in default and considered a distribution, and the plan administrator would be required to report the outstanding amount of the loan as a distribution to her.

Although Frias received four paychecks during her leave, her employer failed to deduct and to remit the loan payments from the amounts paid to her. Frias did not learn about this failure until she returned from her leave. She immediately made a $1,000 payment on November 20, 2012, and instructed her employer to withhold and remit loan payments in the increased amount of $500 through July 15, 2013. After July 15, 2013, Frias continued to make payments of the original loan payment amounts until the loan had been repaid in full on July 9, 2014.

The plan administrator issued an electronic Form 1099-R for 2012, showing a taxable distribution of $40,065, but Frias did not report a distribution for the 2012 loan on her 2012 federal tax return. While the Form 1099-R was available online, and Frias had access to the online website, she did not access or review the Form 1099-R.

On October 6, 2014, IRS issued Frias a notice of deficiency for 2012. IRS determined that Frias had received a taxable distribution from her plan account, was liable for additional tax under §72(t), and was liable for the accuracy-related penalty under §6662.

The Tax Court held that Frias defaulted under the loan agreement since she failed to make her initial loan payment by the due date (August 24, 2012), and failed to make the delinquent payment before the cure period expired. Additionally, the Tax Court determined that Frias did not qualify for the leave-of-absence exception to the substantially level amortization requirement. During the 5-week period that Frias received paychecks from her employer, the amounts were greater than the required installment payments. Thus, she continued to receive compensation payments during the first five weeks of her leave and was required to make installment payments under the loan agreement.

The Tax Court also dismissed several other contentions presented by Frias. Frias argued that:

a. Paychecks she had received during her leave of absence should not be not considered pay. Here, Frias relied on a district court case discussing "wages" for purposes of calculating Social Security benefits, but failed to explain how that term was congruent to "pay" under §72(p) regulations, the Tax Court said.

b. Use of her accrued sick, personal, and vacation time was not "pay" for purposes of Regulation §1.72(p)-1, Q&A 9(a), because the Family and Medical Leave Act (FMLA) allows an employee who is on unpaid leave to use accrued paid vacation, sick, or personal days for all or part of the FMLA leave. However, according to the Tax Court, the right of an employee during FMLA leave to receive payments for leave earned by the employee did not excuse Frias' failure to make loan payments from compensation she received during the first five weeks of her leave.

c. Regulation §1.72(p)-1 did not apply as there was no distribution because (a) all parties to the loan acted as though they agreed to suspend payments; (b) the substance of the repayments should be honored over the form that was required; or (c) Frias corrected the default. The Tax Court found these arguments without merit, because, if there had been an agreement to suspend payments, it should have been in writing or qualifying electronic medium. In addition, there was no evidence that any default was corrected since only a plan sponsor can correct noncompliant loans, and there was no evidence that Frias's employer had requested and received approval from IRS to correct the default.

However, the Tax Court let Frias off the hook for the §6662 accuracy-related penalty, which does not apply to any portion of the underpayment for which the taxpayer shows that there was reasonable cause and that he or she acted in good faith. (§6664(c)(1))

The employer failed to meet its obligation to withhold the loan repayment amounts from Frias's paychecks and transmit the amounts to the plan administrator. As Frias was on maternity leave, and part of her leave period was without pay, she reasonably relied on her employer and plan administrator to withhold required loan payments and properly administer her loan account. Under the circumstances, the Tax Court found it understandable that Frias assumed her loan repayments were being made to the extent the loan agreement required, and her failure to check her earning statements was not fatal.

Thus, while the Tax Court thought that this was a close case, under all of the facts and circumstances, it concluded that Frias had reasonable cause and acted in good faith, and was not liable for the accuracy-related penalty under §6662.

Gowen, TC Summary Opinion 2017-57.

CPA who defaulted on his 401(k) plan loan must include the resultant deemed distribution in gross income in the year that the plan's cure period for repayment expired. The regulations did not entitle him to a 6-month cure period. He also owed the 10% premature withdrawal penalty tax as there is no exception to that tax for financial hardship. Finally, the Tax Court upheld IRS's imposition of the §6662(a) accuracy-related penalty.

Under the general rule of §72(p)(1)(A), taking a loan from a qualified retirement plan results in a deemed distribution that is taxable in the year in which the taxpayer receives the loan. However, §72(p)(2) provides an exception to the general rule for loans that satisfy certain requirements. A loan from a qualified employer plan to a participant or beneficiary is treated as a plan distribution unless:

1. The loan amount does not exceed the lesser of: (1) $50,000, or (2) ½ of the present value of the employee's nonforfeitable accrued benefit under the plan. However, a loan up to $10,000 is allowed, even if it's more than half the employee's accrued benefit. (§72(p)(2)(A))

2. The loan is required to be repaid within five years, (§72(p)(2)(B)(i)) except that a longer repayment can be used for a principal residence plan loan, i.e., a loan used to acquire any dwelling unit which, within a reasonable time, is to be used as the participant's principal residence; (§72(p)(2)(B)(ii))

3. Except as provided in the regulations, the plan loan is amortized in substantially level payments, made not less frequently than quarterly; and (§72(p)(2)(C))

4. The loan must be evidenced by a legally enforceable agreement. (Regulation §1.72(p)-1, Q&A 3)

The §72(p)(2) exception to a loan's being deemed a distribution ceases to apply when the loan from a qualified employer plan no longer satisfies the requirement of §72(p)(2)(C) because the participant fails to make a loan payment either on the date that it is due or within the allowed grace period. Such a failure results in a deemed distribution. (Regulation §1.72(p)-1, Q&A 4)

A plan administrator may allow a cure (grace) period, which cannot continue beyond the last day of the calendar quarter following the calendar quarter in which the required installment payment was due, and §72(p)(2) will not be considered to have been violated if the installment payment is made not later than the end of the cure period. Where there is a failure to pay, the amount of the deemed distribution equals the entire outstanding balance of the loan (including accrued interest) at the time of the failure. (Regulation §1.72(p)-1, Q&A 10)

Early (generally, pre-age 59.5) withdrawals from a qualified retirement plan result in an additional tax equal to 10% of the amounts withdrawn that are includible in gross income. (§72(t)(1)) The additional tax applies unless the taxpayer qualifies for one of several specific exceptions. (§72(t)(2), §72(t)(3)) There is no exception for hardship withdrawals.

Gregory Gowen, a CPA who holds a master's degree in taxation, had been employed by several large international accounting firms, including Ernst & Young, PricewaterhouseCoopers, and KPMG. On March 8, 2012, Gowen borrowed $50,000 from his KPMG 401(k) retirement plan account administered by Merrill Lynch. The terms of the loan required him to make 120 semimonthly payments of $451.72, beginning on March 30, 2012, and ending on March 15, 2017. Gowen initially made the required payments, but after he lost his job at KPMG, he stopped making payments, beginning with a missed payment due on August 30, 2012.

Merrill Lynch sent Gowen a notice dated October 23, 2012, stating: "Our records indicate that your loan payment is past due. Your loan is in danger of being defaulted." The notice also warned that if he defaulted on the loan, its unpaid balance and accrued interest would be reclassified as a withdrawal, the taxable portions of which would be treated as taxable income in the year of the default and also would be subject to the premature withdrawal penalty tax. The notice further stated that the cure or default period expired at the "end of the calendar quarter following the calendar quarter during which the payment was missed." Because the day of Gowen's first missed payment, August 30, 2012, was in the third calendar quarter of 2012, the cure or default period expired on December 31, 2012, the last day of the fourth quarter of 2012.

Merrill Lynch sent Gowen additional default notices on November 26, 2012, and December 26, 2012, repeating the default notifications and warning him of the tax consequences of default. Shortly after the default expiration date, December 31, 2012, the deemed distribution was administratively processed, and Merrill Lynch reported a distribution to Gowen of $46,703, representing the defaulted portion of his $50,000 loan, on Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., sent to both Gowen and IRS. Gowen's correct address was printed on the Form 1099-R; he maintained he never received it. Gowen admitted, however, that he received a distribution statement sent by Merrill Lynch, dated January 7, 2013, which reported the $46,703 deemed distribution.

On his tax return for 2012, Gowen did not report the deemed distribution from Merrill Lynch. Rather, he said that the deemed distribution was includable on his 2013 tax return, claiming that he: (1) did not receive the Form 1099-R, (2) the loan notices he received in 2012 merely warned that his loan was in danger of being in default (but not yet in that state), and (3) it was not until January 7, 2013, that he received the Merrill Lynch distribution statement indicating that a deemed distribution had occurred. Gowen also said his understanding of the regulations was that the cure period was six months, which in his case would have ended in 2013.

Gowen did not report any liability for the §72(t)(1) 10% additional tax on early retirement distributions even though he was 51 years old on December 31, 2012. He claimed the additional tax did not apply because he suffered financial hardship during 2012.

IRS said Gowen should have included the deemed distribution in his 2012 income, and should have paid the 10% penalty tax on it. IRS also said he was liable for the §6662(a) accuracy-related penalty.

The Tax Court pointed out that Regulation §1.72(p)-1, Q&A 10, makes no mention of a 6-month cure period. Rather, it merely provides that the cure period cannot continue beyond the last day of the calendar quarter following the calendar quarter in which the required installment payment was due.

Tellingly, said the Tax Court, Regulation §1.72(p)-1, Q&A 10(c), contains an example that was on point, involving a plan participant who borrowed money from his plan and failed to make the loan payment due on August 31, 2003 (or any month thereafter). If the plan administrator allowed a 3-month cure period, the participant would have a deemed distribution on November 30, 2003, the last day of the 3-month cure period for the August 31, 2003 installment. Alternatively, if the plan administrator had allowed a cure period through the end of the next calendar quarter, the participant would have a deemed distribution on December 31, 2003.

Gowen, like the plan participant in the regulations' example, failed to make the required loan payments in August, which is in the third calendar quarter. His cure period, like the plan participant's cure period in the example, expired at the end of the fourth calendar quarter: December 31. Thus, Gowen, like the plan participant in the example, was deemed to have received a taxable distribution as of December 31, 2012. The fact that Merrill Lynch issued Gowen a statement on January 7, 2013, documenting that a distribution had been made does not change this result. In sum, the Tax Court held that Gowen received a taxable retirement distribution of $46,703 in 2012.

The Tax Court also upheld IRS's determination that Gowen owed the premature withdrawal penalty tax. While Regulation §1.401(k)-1(d)(3)(i) did provide, as Gowen pointed out, that 401(k) plan distributions were permitted in cases of financial hardship, it did not provide for a hardship exception to the 10% additional tax under §72(t)(1).

Finally, the Tax Court also upheld IRS's determination that Gowen owed the §6662(a) accuracy-related penalty, pointing out that he was a CPA who held a master's degree in taxation and had been employed by several large international public accounting firms.

Estate of Hake, (DC PA 2/10/2017) 119 AFTR 2d ¶ 2017-435.

A district court in the Third Circuit, following Third Circuit precedent while acknowledging that courts in other circuits have held differently, has held that an estate that filed its tax return by the date that its tax professional told its executors was the due date, but which was after the actual due date, was not subject to the late-filing penalty because it reasonably relied on the advice of the tax professional.

An estate tax return generally is due within nine months of the decedent's death. (§6075(a)) The federal estate tax is due when the estate tax return is due. (§6051)

Upon submitting Form 4768, an estate is entitled to an automatic six-month extension of time to file an estate tax return. (§6081(a), Regulation §20.6081-1(b)) An extension of time to pay is discretionary and may be granted only for a "reasonable period of time" not to exceed twelve months. (§6161(a), Regulation §20.6161-1(a)(1))

A late payment penalty will be assessed if the taxpayer fails to timely pay taxes owed, unless that failure is due to reasonable cause and not due to willful neglect. (§6651(a)(2)) A taxpayer can establish reasonable cause for failure to timely pay by making a satisfactory showing that he exercised ordinary business care and prudence in providing for the payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship if he paid the tax on the due date. (Regulation §301.6651-1(c)(1))

Esther Hake was the decedent. Two of her sons, Ricky and Randy Hake, were the executors of her estate. There was a dispute among these two sons and Esther's other children with respect to several aspects of the Estate, which, among other things, delayed the preparation of the required tax returns. These same factors led the Hakes to secure, and rely upon, the advice of a law firm.

On advice of the law firm, the Hakes timely filed for extensions to file the estate tax return and pay the estate tax. Ms. Galloway from the law firm informed them that they were granted 1-year extensions to file and to pay.

Part of that advice was wrong, as Regulation §20.6081-1 generally limits any extension to file the Form 706 return to six months for executors located in the U.S. Indeed, the Form 4768 extension request that Galloway prepared and filed specifically provided for a 6-month automatic filing extension and a 1-year discretionary payment extension, with the cover letter that accompanied the Form 4768 expressly requesting "an automatic 6 month extension of time to file a Form 706."

The estate made a prepayment of the taxes in the amount of $900,000, some five months prior to this extended tax payment deadline. This payment was accompanied by a letter in which the executors represented that "we have an extension for filing the Return of July 3, 2013 [i.e., one year after original due date]. Should you have any questions regarding this return, please contact me immediately." IRS did not contact the law firm or the executors about his inaccurate assertion of the Estate's deadline to file its tax return.

The estate then filed its return on July 3, 2013, the date the executors were told it was due. Thereafter, IRS assessed the §6651 late filing penalty.

Following Third Circuit precedent, the Court held that the Estate had reasonable cause for its late filing, and so the Court held that the Estate was not liable for the late filing penalty.

The Court noted that the Supreme Court in *Boyle,* (S Ct 1985) 55 AFTR 2d 85-1535, ruled on an issue of late filing resulting from an error by professional advisors. In Estate of *Thouron*, (CA 3 2014) 113 AFTR 2d 2014-2082, the Third Circuit, i.e., the circuit to which an appeal of the current case would be heard, read *Boyle* to have identified the following distinct categories of late-filing cases: The first category consists of cases that involve taxpayers who delegate the task of filing a return to an agent, only to have the agent file the return late or not at all. In *Boyle*, the Supreme Court held that, in such cases, reliance upon one's attorney to file a timely tax return was not reasonable cause to excuse the late filing. The second category of late-filed cases is where a taxpayer, in reliance on the advice of an accountant or attorney, files a return after the actual due date, but within the time that the taxpayer's lawyer or accountant advised the taxpayer was available.

The *Boyle* court held that the executor could not hide behind the oversight of his attorney because executors have a clear obligation to make sure that estate tax returns are filed timely "that cannot be discharged by delegating responsibility to an attorney or accountant."

The *Thouron* court construed *Boyle* narrowly, stating that *Boyle* addresses only cases of "clerical oversight," where a taxpayer has simply relied on a third party to file a return by the prescribed deadline. *Thouron* found reasonable cause in the case before it, which involved the following circumstances: An estate promptly requested a filing extension, but, instead of filing a payment extension at that time, paid $6.5 million, which it knew was a fraction of its estate tax liability. It did this under the direction of its attorney, who advised that the estate qualified to pay its estate tax liability in installments over several years. However, after the due date for paying the tax, the attorney determined that the estate did not qualify to pay its tax in installments and had the estate, at that point, request a payment extension. IRS denied the request and assessed a late payment penalty. The *Thouron* court ruled that the penalty did not apply because the estate reasonably relied on the legal advice of counsel.

In reaching this determination, the *Thouron* court noted that *Boyle* had recognized a split of authority regarding the second category of cases, where the estate either paid or filed late, but did so by or before the deadline that its lawyer had instructed. In observing that the *Boyle* court explicitly declined to resolve this split among the circuits, the *Thouron* court noted that the Third Circuit, in *Sanderling, Inc.,* (CA 3 1978) 41 AFTR 2d 78-831, had previously held that "a taxpayer could show reasonable cause where he or she filed (or paid) before what he or she was erroneously advised was the deadline."

IRS argued that it is irrelevant whether the Estate wholly delegated their duty to administer the Estate to their lawyer, since *Boyle* should be read more broadly for the proposition that the statutory requirement for timely filing a return is solely the duty of the taxpayer, and is non-delegable. The Court said that such an argument, however, invites the Court to ignore the *Thouron* court's instruction that the holding of *Boyle* does not reach the very circumstances of this case, where the executors did not delegate their filing duty to their lawyer, but where they did rely upon their lawyer to advise them when their taxes needed to be paid and their return filed. The Court said that, given the Third Circuit's limited interpretation of *Boyle*'s holding in *Thouron*, and the fact that the Supreme Court itself noted that it's holding did not reach the very circumstances presented in this case, it disagreed that *Boyle* compels a ruling in the government's favor.

The Court said that this case aptly illustrated how such reliance upon expert advice can be objectively reasonable. There was nothing immediately intuitive about the determination of the deadlines in this case. Instead, in order to ascertain when taxes needed to be paid and returns needed to be filed, the executors would have had to learn a large number of rules. For example, they would have to identify the initial filing and payment deadlines and then navigate a series of extension rules, some of which are automatic and others of which are discretionary. The executors would then have had to recognize that the interplay of these automatic and discretionary extension rules would lead to material differences in payment and filing deadlines. Given the complexity of these rules, the Court said, it is hardly surprising that even experienced counsel may sometimes become confused.

Moreover, the Court said, the law firm's advice and the executors' reliance on it was eminently reasonable and prudent under the circumstances, where inexperienced executors were buffeted by and contending with intra-family disputes over asset valuations and other matters that hampered their ability to fulfill their legal obligations. Moreover, nothing in the record "remotely suggest[ed]" that the executors were cavalier in their attention to the tax rules, or were seeking to do anything other than ensure that the Estate paid its taxes faithfully. Indeed, the executors paid the estate taxes before they were due and even overpaid those taxes.

Finally, the Court said that, in reaching its result, it recognized that some other courts have interpreted *Boyle* in the manner urged by IRS, and on facts that are substantially similar to those presented in this case. "Were we writing upon a blank slate, these cases might have persuasive power, but we do not write upon a blank slate. This Court is obligated to follow Third Circuit precedent."

Hurford Investments No. 2, LTD v. Commissioner 2017 BL 138848 (T.C. April 17, 2017)).

Tax Court grants taxpayer's motion for summary judgment, concluding that a partnership had long-term capital gain on the termination of a phantom stock plan with a stepped-up basis. The Court, rejecting IRS's various arguments, found that (a) the phantom stock was a capital asset; (b) there was a sale or exchange; and (c) the partnership's basis was a stepped-up basis.

Under §691(a)(1), income the decedent earned and would have received if he would have lived (income in respect of a decedent, or IRD) is taxed to the recipient in the year of actual receipt, that is, to either the estate, legatee, devisee, or next of kin, according to who is entitled to it.

Under §691(a)(2), a transfer by a decedent's estate or by the heir, devisee or other beneficiary of a right to IRD, is considered as the realization of the decedent's income. For the tax year of the transfer, the transferor who received the right by reason of the decedent's death must include in gross income the full fair market value of the right as of the time of the transfer. And, if the transferor received an amount in the transfer that exceeded that fair market value, he must also include that excess in income.

§691(a)(3) provides that the character of IRD in the hands of the recipient is the same as it would have been in the hands of the decedent had he lived and received the amount. The nature of the decedent's transaction in which the right to the income originated carries over to the taxation of the after-death income to the decedent's estate or beneficiaries.

§1221 defines the term "capital asset" very broadly as all property that is not specifically excluded by one of a list of exceptions. (§1221(a), Regulation §1.1221-1(a)) To receive capital gains rates, the income must be from a "sale or exchange" of the capital asset. (§1222)

Under the substitute-for-ordinary-income doctrine, capital gain treatment is not available where the substance of what is sold is the right to receive future ordinary income and the substance of what is received is the present value of ordinary income which the seller would otherwise receive in the future. In such a case, there is ordinary income rather than capital gain, since consideration is paid for the right to receive future income, not for an increase in the value of the income-producing property.

For example, a state lottery winner who sells or assigns, for a lump sum, his right to receive future installments of lottery winnings, recognizes ordinary income, not capital gain.

§1234A provides that gains or losses are capital gains or losses if they are attributable to a cancellation, lapse, expiration, or other termination of a right or obligation (other than a securities futures contract) as to property if the property is (or would be, if acquired) a capital asset in the hands of the taxpayer.

The Fifth Circuit held that §1234A applies only to the termination of rights or obligations to buy or sell capital assets, not the termination of their ownership. Thus, where taxpayer could have received $20 million on the redemption of securities, but instead voluntarily surrendered them because the tax savings from an ordinary abandonment loss would have exceeded $20 million, the abandonment loss was an ordinary loss. *(Pilgrim's Pride Corp v. Commissioner*, (CA 5 2015) 115 AFTR 2d 2015-930, rev'g (2013) 141 TC 533)

Gary Hurford held phantom stock in the Hunt Oil Company until he died in 1999. His wife, Thelma Hurford, who inherited it, decided to transfer the phantom stock in 2000 to Hurford Investments No. 2, Ltd. (HI-2), a partnership that was created to hold the stock. Hunt Oil wrote her at the start of 2001 to say that it formally recognized HI-2 as the holder of the phantom stock as of March 22, 2000. Thelma died in February 2001.

The phantom stock was not actually stock, but instead a form of deferred compensation that Hunt Oil gave to employees which allowed them to share in the company's growth without the Hunt family having to dilute their own equity. Each "share" of phantom stock was valued at approximately the price of a share of Hunt Oil common stock, as fixed by Hunt Oil each year on December 31. The dollar amount reported on Gary's estate tax return was its value on December 31, 1998.

The phantom-stock agreement included a "qualified termination of service" clause under which Gary's death triggered a 5-year countdown. During these five years, the phantom shares would grow or decline with the value of the company and would also continue to earn any dividends. But at the end of the fifth year, the company would automatically "redeem" the stock and create an interest-bearing "phantom account" on its books equal to the value of the shares. This account balance could also fluctuate with the company's value: if the company's stockholder equity fell, the account's value would fall by an equal percentage, and if it rose, the account's value would rise by the lesser of the percentage rise in the company stockholder equity or the 90-day Treasury rate. Whoever held the account-or Hunt Oil at its option-could cash it out at any time.

At the time of transfer, the value of the phantom stock was $6.4 million. Thelma had never reported her receipt of the phantom stock on her income tax returns, but HI-2 reported this transfer on its 2000 Form 1065 as a $6.4 million short-term capital gain.

In *Estate of Hurford,* TC Memo 2008-278, the Tax Court held the value of the phantom stock had to be included in Thelma Hurford's taxable estate. This value, measured at the time of her death, was a little over $9.6 million, an increase in value of more than $3.2 million from when Hunt Oil recognized HI-2 as its owner. The 5-year clock on the phantom stock ended in 2004. Hunt Oil redeemed the stock as required. In 2006 the company decided to liquidate the successor phantom account and distribute almost $13 million to HI-2.

On its 2006 Form 1065, HI-2 reported about $6.5 million as ordinary income; this was the difference between the value at the time of distribution minus the amount reported in 2000 as short-term capital gain.

On audit, IRS asserted that HI-2's initial reporting position was wrong. IRS argued that the reported income should have been reported as long-term capital gain, not ordinary income, and that the amount should have been only about $3.3 million-the difference between the value at the time of distribution and the value at the time of Thelma's death. HI-2 sought relief in the Tax Court.

In a closing agreement before the Tax Court executed in 2011, HI-2 and IRS agreed that $6.4 million was the value of the phantom stock and it should be classified as IRD under §691. They also agreed that HI-2 received basis in its phantom-stock interest of the same amount, $6.4 million. Each party moved for summary judgment.

IRS argued that because of Estate of Hurford, res judicata-the doctrine that precludes a party from re-litigating issues that were or could have been raised in an earlier proceeding-established that HI-2 was not a valid partnership for federal income tax purposes and that there was no transfer of the phantom stock until Thelma died. And, since the phantom stock was deferred compensation, the distribution to HI-2 should be taxed as ordinary income. Further, even if the phantom stock was a capital asset, the payment in 2006 was not a sale or exchange under §1222, so HI-2 could not get capital gains treatment.

On the other hand, HI-2 argued that the character of the distribution was long-term capital gain that should be recognized in 2006. While the value of the phantom stock in the hands of Thelma was IRD (and thus taxable as ordinary income to her if IRS had chosen to do so back then-which it did not), the phantom stock became a capital asset in its hands after the transfer, resulting in long-term capital gain in 2006 when Hunt Oil liquidated the phantom stock account.

HI-2 also argued that it should get a step-up in basis-measuring the gain as the difference between the phantom account's value at the time of distribution and the phantom stock's value at the date of Thelma's death in 2001-because Thelma triggered §691(a)(2) when she transferred the phantom stock before her death. Because Estate of Hurford held that the value of the phantom stock on the date of Thelma's death (just over $9.6 million) was part of her estate in 2001, HI-2 argued that it should get a stepped-up basis in its phantom stock to equal this value and not the $6.4 million value on the date of Thelma's transfer to HI-2.

The Tax Court held that HI-2 was entitled to consider the income it received on termination of the phantom stock plan as long-term capital gain, and its basis as equal to the $9.6 million fair market value of the phantom stock on the date of Thelma's death.

The Court rejected IRS's res judicata argument: Estate of Hurford was about estate tax and was limited to the claim that the notice of deficiency sent to the estate and adjusting the estate tax was wrong; no party to that proceeding could have brought a claim that IRS erred in determining a deficiency in HI-2's income tax from years later. Further, there was no earlier litigation on the issue of whether HI-2 was a sham partnership that should be disregarded for tax purposes.

The Court concluded that, under §691(a)(2), Thelma should have reported the phantom stock's value at the time of the transfer of the phantom stock to HI-2. Under §691(a)(3), she should have reported it as ordinary income.

The Court determined that HI-2's interest in the phantom stock did not fit into one of the exceptions listed in §1221, and so concluded that it was a capital asset.

It also found that the exception to this treatment under the substitute-for-ordinary-income doctrine did not apply. The Court reasoned that if Gary had lived to see the liquidation of the phantom account, it would have been deferred compensation taxed as ordinary income. But the character of property can change when it's transferred to another party, so the character in the hands of Gary or

Thelma was not automatically applicable to HI-2. In *Davis,* (2002) 119 TC 1, the Tax Court said that it was well established that capital gains treatment is intended only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, thus ameliorating the hardship of taxation of the entire gain in one year. Here, the phantom stock could increase or decrease in value over time, similar to ordinary stock. Once HI-2 acquired it, its value was inextricably linked to the value of Hunt Oil. Unlike Gary, HI-2 could not do anything to affect its value, but rather simply held it and hoped it would appreciate in value. The Tax Court found that this was a distinguishing enough characteristic for it to conclude that it was a capital asset of HI-2's.

The Tax Court determined that HI-2's situation was a termination of a right to buy or sell a capital asset, and not an abandonment of property, under the Fifth Circuit's interpretation of §1234A(1) in Pilgrim's Pride. While both parties to the phantom stock arrangement had the right to liquidate the account at any time, when Hunt Oil liquidated the phantom stock and distributed the proceeds, it ended HI-2's right to sell the phantom stock when it chose. HI-2 still owned the rights to the phantom stock or, after the liquidation, to the cash proceeds. The Court concluded that the transaction was a sale or exchange of a right to sell a capital asset under §1234A(1), and HI-2 was entitled to capital gains treatment.

The Court also agreed that HI-2 was entitled to a step up in basis to $9.6 million-the phantom stock's value at the time of Thelma's death. While Thelma was not yet a "decedent" at the time she contributed the phantom stock to HI-2, under §1014(b)(9), property is considered "to have been acquired from or to have passed from the decedent...if by reason thereof the property is required to be included in determining the value of the decedent's gross estate." The Court further found that the exception to this exception under §1014(c) -which specifically excludes from the step up in basis "property which constitutes a right to receive an item of income in respect of a decedent under section 691"-did not apply: the Tax Court had already determined that the phantom stock was transformed into a capital asset in the hands of HI-2, so it was no longer an item of IRD.

Losantiville Country Club, TC Memo 2017-158.

Because a §501(c)(7) social club did not intend to profit from its nonmember sales, it could not offset its investment income, which was unrelated business taxable income, with losses relating to these sales.

Under §501(c)(7), clubs organized for pleasure, recreation and other nonprofitable purposes are tax exempt if substantially all of their activities are for those purposes, and no part of their net earnings inures to the benefit of any private shareholder. A club may receive up to 35% of its gross receipts from outside income. Within this 35%, not more than 15% of gross receipts may be derived from the use of the club's facilities or services by the general public.

In general, organizations that are otherwise exempt from taxation under §501(a) are subject to tax on income from an unrelated trade or business (referred to as unrelated business taxable income, or UBTI). (§511, §512, §513)

For social clubs and certain other exempt organizations-i.e., voluntary employees' beneficiary associations (VEBAs) and supplemental unemployment compensation benefit trusts (SUBs)-UBTI means gross income (excluding any "exempt function income"), less deductions that are directly connected with the production of gross income (excluding exempt function income), both computed with certain modifications relating to net operating losses, certain charitable contributions and specific deductions. (§512(a)(3)(A))

Exempt function income of social clubs, VEBAs, and SUBs is: (a) gross income from dues, fees, charges or similar amounts paid by members of the organization as consideration for providing the members or their dependents or guests goods, facilities or services in furtherance of the purposes constituting the organization's basis for exemption; and passive income set aside for certain purposes. (§512(a)(3)(B))

Resolving a conflict in the circuits, the Supreme Court in *Portland Golf Club v. Com.,* (S Ct 1990) 65 AFTR 2d 90-1162, held that in computing UBTI, a tax-exempt social club may use losses incurred in sales to nonmembers to offset investment income, but only if those sales were motivated by a desire for profit. Since the only deduction that could apply to the social club's food, payroll, and overhead expenses in excess of gross receipts from nonmembers sales was that provided for in §162, and amounts were deductible under §162 only if there was a profit motive, a profit motive was required with respect to sales to nonmembers.

A 20% accuracy-related penalty applies under §6662(a) where there is an underpayment attributable to negligence or disregard of rules or regulations. (§6662(b)(1)) The accuracy-related penalty does not apply to any portion of the underpayment for which the taxpayer shows that there was reasonable cause and that he or she acted in good faith. (§6664(c)(1))

Losantiville Country Club (Club) is a §501(c)(7) social club. Its facilities include an 18-hole golf course, a swimming pool, tennis courts, dining facilities, meeting and reception rooms, and associated grounds maintained for the benefit of members and guests. Members pay for the use of its facilities through dues, assessments, food minimums, and miscellaneous fees. Nonmembers pay surcharges to use its facilities.

On its Forms 990-T (Exempt Organization Business Income Tax Return) Club reported gross receipts, direct expenses (i.e., costs of goods sold), and indirect expenses (i.e., salaries and wages, employee benefits, repairs, depreciation, grounds maintenance, supplies, and general and administrative expenses) relating to its nonmember sales activities. It computed the indirect expenses relating to its nonmember sales using the gross-to-gross allocation method. Under this allocation method, Club used the ratio of nonmember sales to total sales to determine what portion of indirect expenses was attributable to nonmember sales. For 2010, 2011, and 2012, its net losses relating to nonmember sales were $112,365, $93,524, and $99,522, respectively. On its 2010, 2011, and 2012 Forms 990-T, Club also reported investment income (i.e., interest and dividends) of $30,723, $7,274, and $7,340, respectively.

On its amended 2010 Form 990-T and its original 2011 and 2012 Forms 990-T, Club offset its investment income with losses attributable to its nonmember sales and reported that it did not have UBTI. Club's accountants prepared these forms. In preparing and filing these forms, Club and its accountants were aware that, under Portland Golf Club, losses from nonmember sales may offset investment income only if the sales were entered into for profit.

On audit, IRS determined that Club's nonmember sales activities were not entered into for profit that these sales could not offset its investment income, and that Club investment income was UBTI. IRS also asserted §6662 accuracy-related penalties.

Club contended that its nonmember sales activities were entered into for profit, and that its intent to profit could be established under Regulation §1.183-2(b). Under the so-called "hobby loss rules," if an activity is not engaged in for profit, deductions generally are disallowed by §183 except to the extent of the gross income derived from the activity for the tax year. Regulation §1.183-2(b) enumerates nine factors to consider in determining whether a taxpayer has a profit objective, including, among others, the taxpayer's expertise, the time and effort expended by the taxpayer in carrying out the activity, the amount of any occasional profits, and the taxpayer's financial status. The list is not exhaustive, and no single factor is conclusive.

The Tax Court found that because Club did not intend to profit from its nonmember sales, it could not offset its investment income with losses relating to these sales.

The Court reasoned that expenses in excess of unrelated business income are deductible only to the extent that a §501(c)(7) organization intends to profit from its unrelated business activities. Thus, under Portland Golf Club, Club may offset investment income with losses incurred in sales to nonmembers only if its nonmember sales were motivated by an intent to profit. To prove its intent to profit, Club would have to show that its gross receipts from nonmember sales exceeded the direct and indirect costs relating to these sales. Under the gross-to-gross method, Club sustained losses relating to nonmember sales during the years in issue.

The Tax Court rejected Club's contention that its intent to profit could be established by the factors set out in Regulation §1.183-2(b). The Court concluded that §183 and its regulations were not applicable to §501(c)(7) organizations.

The Tax Court, finding that Club failed to exercise due care in the preparation of its returns, held that it was liable for a §6662(a) accuracy-related penalty for negligence and disregard of the rules and regulations. While Club's 2010, 2011, and 2012 returns were prepared by professionals, there was no evidence that the preparers had sufficient expertise to justify reliance that Club provided them with the necessary and accurate information, or that Club relied in good faith on the preparers' judgment. To the contrary, the Court found that Club stipulated that it and its accountants were aware of the Portland Golf Club precedent. Thus, Club's returns were not prepared in good faith, and Club did not have reasonable cause for the underpayments under §6664(c)(1).

McGaugh, (CA 7 6/26/2017) 119 AFTR 2d ¶ 2017-903.

The Court of Appeals for the Seventh Circuit, affirming the Tax Court, has ruled that there was not a taxable distribution to the owner of a self-directed IRA who directed the IRA custodian to wire cash to purchase shares of a private company, where the certificate for those shares was apparently delivered to the custodian after the 60-day rollover period in §408(d)(3), and the custodian did not deposit the shares into the IRA.

Generally, amounts distributed from an IRA are includible in a taxpayer's gross income as provided in §72. (§408(d)(1)) However, under §408(d)(3), a distribution is not includible in gross income if the entire amount of the distribution an individual receives is paid into an IRA or other eligible retirement plan ("rolled over") within 60 days of the distribution. (§408(d)(3)(B)) A distribution rolled over after the 60-day period generally will be taxed (and also may be subject to a 10% premature withdrawal penalty tax). (§72(t))

Under the doctrine of constructive receipt, a person receives income "not only when paid in hand but also when the economic value is within the taxpayer's control." (*Fletcher,* (CA 7 2009) 103 AFTR 2d 2009-1674) Constructive receipt thus occurs where income "is credited to [an individual's] account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions." (Regulation §1.451-2(a))

The taxpayer, Raymond McGaugh, had an IRA with Merrill Lynch. In the summer of 2011, he requested that Merrill Lynch use money from that IRA to purchase 7,500 shares of stock issued by First Personal Financial Corporation (FPFC), a privately held company. For reasons that were not clear from the record, Merrill Lynch would not purchase those shares on McGaugh's behalf. So, McGaugh called Merrill Lynch and initiated a wire transfer of $50,000 from his IRA directly to FPFC, which occurred on October 7, 2011.

On November 28, 2011, FPFC issued a stock certificate titled "Raymond McGaugh IRA FBO Raymond McGaugh," which it mailed to Merrill Lynch. Merrill Lynch said it did not receive this certificate until "early 2012" (though FPFC claimed to have sent it earlier). After receiving the certificate, Merrill Lynch did not retain it, believing McGaugh's transaction to have impermissibly exceeded the 60-day window applicable to rollovers of IRA assets under §408(d)(3). Rather, Merrill Lynch attempted to send the certificate to McGaugh twice in February 2012, but the United States Postal Service returned it both times. McGaugh requested a replacement share certificate, but FPFC refused to issue one without first receiving indemnification from Merrill Lynch. Merrill Lynch then sent the certificate to McGaugh a third time via FedEx, and it was not returned. The shares were never deposited into McGaugh's IRA. The location of the share certificate was never determined.

Believing the transaction to be subject to the rollover rules and the transfer to be outside the §408(d)(3) 60-day limit, Merrill Lynch reported the $50,000 transaction as a taxable distribution on Form 1099-R, "Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc." and refused to treat the FPFC stock as an asset of the IRA.

IRS issued a notice of deficiency, which indicated that McGaugh had failed to report a $50,000 distribution for the tax year 2011.

McGaugh then filed suit, contending that this was an error. The Tax Court agreed with McGaugh. (*McGaugh,* TC Memo 2016-28) IRS appealed this decision.

Whether the transaction involving the removal of $50,000 from McGaugh's IRA to purchase stock for his IRA constituted a distribution that was not rolled over within the 60-day period allowed in §408(d)(3), and so was taxable income.

The Court affirmed the Tax Court's finding that there was no taxable distribution. It held that McGaugh never received a distribution from the IRA. Accordingly, the 60-day limitation on a rollover under §408(d)(3) did not come into play. The timing of the mailing of the shares (i.e., more than 60 days after the wire transfer) did not alter the Court's conclusion that there was no distribution from the IRA to McGaugh.

IRS argued that, although McGaugh never physically received any cash or other assets from his IRA during the 2011 tax year, McGaugh took a distribution because he constructively received IRA proceeds.

The Court said that there was no evidence that McGaugh was in constructive receipt of assets from his IRA. First, it said that it was clear McGaugh did not constructively receive stock. The FPFC share certificate was never in his physical possession during the 2011 tax year. There was also no evidence that he had any control over those shares or the rights associated with them that could give rise to a finding of constructive receipt. The share certificate was issued in the name of "Raymond McGaugh IRA FBO Raymond McGaugh" rather than McGaugh's own name.

IRS contended that McGaugh's decision to title the stock certificate in the name of his IRA amounted to a self-imposed restriction insufficient to avoid constructive receipt. The Court said that it did not believe holding securities in a tax shelter is the sort of end-run around possession the constructive receipt doctrine is intended to address. Moreover, the Court said, even though McGaugh may have made the initial decision to purchase FPFC stock, once he did so he had no control over that stock, as evidenced by FPFC's refusal to issue a replacement share certificate without first receiving indemnification from Merrill Lynch.

But IRS's primary argument was that McGaugh constructively received funds from his IRA when he directed Merrill Lynch to wire them at his discretion to FPFC. It noted that a party cannot circumvent the rules on taxable income simply by directing a distribution to a third party.

The Court agreed that it has recognized "this commonsense proposition" before. For example, in Fletcher, it said that "a person who earns income cannot avoid tax by telling his employer to send a paycheck to his college, or his son, rather than to his bank." However, it said, IRS's proposition was not implicated in this case. McGaugh did not direct a distribution to a third party; he bought stock. "That is a prototypical, permissible IRA transaction." Constructive receipt concerns not whether a deferred compensation plan participant can participate in the plan's choice of investments but whether the funds were made currently available to the plan participant to meet immediate financial needs. Further, there was no indication that McGaugh orchestrated this purchase for the benefit of FPFC or for any reason other than because he wished to obtain stock to be held in his IRA. Thus, there was no evidence that he constructively received funds, either in ordering Merrill Lynch to wire funds to FPFC or in any other respect.

McGuire, (2017) 149 TC No. 9.

Taxpayers who did not qualify for the premium tax credit (PTC) because their modified adjusted gross income (MAGI) exceeded 400% of the federal poverty level (FPL) had to repay all the advance premium tax credit (APTC) paid on their behalf to their insurer. This result was not changed by the facts that they did not receive a Form 1095-A to calculate their PTCs or that they made repeated, but futile, attempts to contact their health insurance exchange to advise it about their change in financial circumstances. However, the taxpayers were found not liable for any addition to tax.

Under the Affordable Care Act (ACA), a PTC is available to help individuals and families afford the cost of premiums for qualified health plans purchased through a health insurance *Marketplace.* (§36B) A health insurance Marketplace, also known as an "Exchange," is a State or federally run program where taxpayers can purchase health insurance. In general, an individual is eligible for the PTC if: (i) his or her household income is at least 100% but not more than 400% of the FPL for the individual's family size, (ii) no one can claim the individual as a dependent, and (iii) if married, the individual files a joint return.

Eligible individuals and families can choose to have advance credit payments (i.e., APTCs) paid directly to their insurance company to lower what they pay out-of-pocket for their monthly premiums. Where APTCs paid to taxpayer's insurer for the tax year exceed the PTC to which the taxpayer is actually entitled for the tax year, the taxpayer generally owes the excess advance payments as an additional income tax liability. (§36B(f)(2)(A)) Under §36B(f)(2)(B), there are limits on the additional tax liability for a taxpayer whose household income is less than 400% of the FPL for a family of the size involved. However, there are no limits for a taxpayer whose household income exceeds 400% of the relevant FPL.

Observation: In other words, the 400% limitation is a "cliff"; for example, a taxpayer whose income is 401% of FPL does not qualify for any credit and, if he erroneously received an APTC, he would have to repay the entire amount.

Household income is an individual's MAGI plus that of every other individual in his family for whom he or she can properly claim a personal exemption as a dependent, who is required to file a federal income tax return. MAGI is the adjusted gross income on one's federal income tax return plus any excluded foreign income, nontaxable Social Security benefits, and tax-exempt interest received or accrued during the tax year. For this purpose, MAGI does not include Supplemental Security Income (SSI). (§36B(d)(2); Regulation §1.36B-1(e)(1))

By January 31 of the year following the year of coverage, a Marketplace is required to send individuals an information statement on Form 1095-A (Health Insurance Marketplace Statement) showing the amount of a taxpayer's premiums and advance credit payments. Form 8962 (Premium Tax Credit) is filed with the taxpayer's return to figure the amount of his PTC, and reconcile it with any APTCs.

A 20% accuracy-related penalty under §6662(a) is imposed against any portion of an underpayment of tax that is attributable to a substantial understatement of income tax. (§6662(b)(2), §6662(d)) An understatement of tax is substantial if it exceeds the greater of $5,000 or 10% of the tax required to be shown on the taxpayer's return. (§6662(d)(1))

However, the accuracy-related penalty does not apply to any portion of the underpayment for which the taxpayer shows that there was reasonable cause and that he acted in good faith. (§6664(c)(1)) Circumstances that indicate reasonable cause and good faith include reliance on the advice of a tax professional or an honest misunderstanding of the law that is reasonable in the light of all the facts and circumstances. (Regulation §1.6664-4(b))

Mr. and Mrs. McGuire applied for and received an APTC under the ACA. That credit was paid directly to a health insurance provider to reduce the amount of the premium to be paid by them.

Mr. McGuire was drawing roughly $800 per week from his parts and service business, and Mrs. McGuire was not working. On the basis of their household income, Covered California, a health insurance exchange created under the ACA, determined that they were eligible for an APTC of $591 per month to be applied to their monthly health insurance premium, for a total annual credit of $7,092. They enrolled in the Blue Shield Silver 70 PPO plan, with a monthly premium of $1,182. After application of the APTC, they were responsible for only $591 of that premium.

After the eligibility determination but still in 2013, Mrs. McGuire began working at a job that paid her $600 per week. She promptly notified Covered California, acknowledging that this amount "needs to be included in our annual income." This change of income was significant in that 400% of the Federal poverty line for a family of two residing in California at the time was $62,040, and Mrs. McGuire's new job was almost certain to put the McGuires over that limit.

Several months later, Covered California acknowledged the change in household income, sending a letter dated June 14, 2014, advising the McGuires that they did not qualify for an Enhanced Silver Plan because their household income was too high. However, the McGuires never received the letter. What exactly happened to that letter was unclear: the records from Covered California that were provided in this case were incomplete. What the record made clear was that the McGuires made repeated efforts to get Covered California to take into account the change in household income, but it never did so.

As a result of a change in financial circumstances, the McGuires ultimately were not entitled to the PTC. After the close of the tax year, they did not receive a Form 1095-A. The McGuires did not report the excess tax credit as an increase to tax on their return.

On their 2014 return, the McGuires checked the box on Form 1040, U.S. Individual Income Tax Return, line 61, which reads "Health care: individual responsibility (see instructions) Full year coverage." On their return, the McGuires left blank line 69, labeled "Net premium tax credit. Attach Form 8962. " The accompanying instructions were silent as to how this line might relate to an APTC, although they cross-reference the instructions to Form 8962, which did discuss excess APTC. There was no evidence indicating that the McGuires, who retained a tax return preparer, were made aware of these various instructions. Nowhere on their return did they report their APTC of $7,092.

On audit, IRS issued a notice of deficiency disallowing the $7,092 APTC, the effect of which was to increase their tax liability in the amount of that disallowed credit. IRS also determined an accuracy-related penalty.

The McGuires argued that they were trapped in a health plan that they could not afford without the subsidy provided by the ACA, and they asked the Tax Court to rule "fairly and justly" or, otherwise stated, equitably. They stated that they would never have committed to paying for medical coverage in excess of $14,000 per year. They could not afford it and would have continued to shop in the private sector to purchase the minimal, least expensive coverage or gone without coverage completely and suffered the penalties. If they were deemed responsible for paying back this deficiency, they said it would be devastating.

The Tax Court determined that the McGuires were liable for the $7,092 deficiency. While sympathetic to the taxpayers' situation, the Court found that it did not have the equitable power to override the clear and unambiguous language of the Code: under §36B(f)(2), excess premium assistance credits are an increase in tax.

The Court further held that, on the facts of this case, the McGuires were not liable for an accuracy-related penalty. On the totality of the facts and circumstances, they acted reasonably and in good faith with respect to the underpayment of tax on their return. They did not receive a Form 1095-A showing the income they received in the form of an APTC, and they did not directly receive that income. They did not know nor should they have known that they had additional income required to be shown on their return, and consequently they were not liable for the accuracy-related penalty under §6662(a).

The Court reasoned that the fact that a taxpayer does not receive an information return, standing alone, generally does not give rise to reasonable cause under §6664. In the typical case, the taxpayer will have received income during the year, and even if the taxpayer did not receive the information return, the taxpayer received the income and should have known to report it. However, the nonreceipt of an information return may contribute to a reasonable cause and good-faith defense when a taxpayer neither knows nor has reason to know that he or she has received taxable income. Another fact or circumstance that can contribute to a reasonable cause and good-faith defense is a liability that is caused by a third party's failure to act. And a taxpayer's reliance on the advice of a qualified tax professional can also contribute to a reasonable cause and good-faith defense to a substantial understatement penalty.

The Court found that the McGuires did not receive a Form 1095-A. Although they received a benefit in the form of an APTC to pay health insurance premiums, it was the insurance company and not the McGuires that received the payments. Not only did the McGuires not receive the Form 1095-A, but they also were not the actual recipients of the payments that would have been reported on that form. The McGuires did not have notice that they were being charged with taxable income. Like the taxpayers in Frias, TC Memo 2017-139 (where the taxpayer's nonreceipt of a form advising her that her plan loan had been treated as a deemed distribution was compounded by her reasonable reliance on her employer's agreement to withhold the loan repayment amounts), and *Nipps*, TC Memo 2011-267 (where the taxpayer inherited an individual retirement account, and chose to have the financial institution withhold the taxes, but it failed to do so), the McGuires relied on a third party to fulfill its obligations. They reported their change in financial circumstances to Covered California and relied on Covered California to properly determine and adjust their eligibility for the PTC. For whatever reason, that did not happen.

Further, the Court found that while the record was sparse, it showed that the McGuires relied on a certified public accountant to properly prepare their tax return.

Medical College of Wisconsin Affiliated Hospitals, Inc. v. U.S., (CA 7 04/25/2017) 119 AFTR 2d ¶2017-698.

The Court of Appeals for the Seventh Circuit, affirming a district court, has joined the Second and Sixth Circuits in concluding that the interest rate IRS is required to pay with respect to tax overpayments by corporations, which is a lower rate than that which applies to overpayments by other taxpayers, applies to overpayments by non-profit corporations.

For noncorporate taxpayers, the interest rate on overpayments of tax generally is the federal short-term rate plus three percentage points. For corporate taxpayers, the interest rate on overpayments of tax is the federal short-term rate plus two percentage points. (§6621(a)(1)(B)) However, §6621(a)(1) provides in its flush language (i.e., a part of the Code section that is without a number or letter and that is set out flush against the margin):

"To the extent that an overpayment of tax by a corporation for any taxable period (as defined in subsection (c)(3) [§6621(c)(3)), applied by substituting "overpayment" for "underpayment") exceeds $10,000, subparagraph (B) (§6621(a)(1)(B)) shall be applied by substituting "0.5 percentage point" for "2 percentage points" [that is, the interest rate is the federal short-term rate plus 0.5 percentage points]."

§6621(c)(1) provides the underpayment rate on any large corporate underpayment, which is a higher rate than the regular underpayment rate. §6621(c)(3), in turn, defines two terms: (1) a "large corporate underpayment," which is defined as an underpayment of over $100,000 by a C corporation for any taxable period; (§6621(c)(3)(A)) and (2) "taxable period," which is defined as, for income tax overpayments, the corporation's tax year, and for overpayments of other taxes, the period to which the overpayment relates. (§6621(c)(3)(B))

The taxpayer, Medical College of Wisconsin Affiliate Hospitals, Inc. (Hospital), is organized as a domestic not-for-profit corporation under Wisconsin law. Pursuant to §501(a), it is exempt from federal income tax. It is not exempt, however, from paying FICA taxes.

IRS refunded to the Hospital approximately $14 million in overpaid employer-portion FICA tax plus approximately $13 million in interest on that tax. Sometime later though, IRS formally notified the Hospital that IRS had overpaid the interest refunded and demanded repayment of approximately $6.7 million. The approximately $6.7 million equaled the difference between the statutory interest rates for a corporation versus a noncorporate taxpayer under §6621(a)(1).

The Hospital repaid the approximately $6.7 million in interest. It then claimed a refund for the approximately $6.7 million in interest (plus interest on this amount) and eventually sought relief in the district court.

Relying on the language of the statute and the Second Circuit's decision in *Maimonides Medical Center,* (CA 2 2015) 116 AFTR 2d 2015-7091, and the Sixth Circuit's decision in *Detroit Medical Center,* (CA 6 2016) 118 AFTR 2d 2016-5530, the district court concluded that the interest rate that IRS was required to pay with respect to tax overpayments by corporations applies to overpayments by non-profit corporations. (*Medical College of Wisconsin Affiliate Hospitals, Inc. v. U.S.*, (DC WI 9/14/2016) 118 AFTR 2d 2016-5798)

The district court specifically rejected the Hospital's argument that the parenthetical in the flush language of §6621 incorporates the C corporation limitation of §6621(c)(3)(A), notwithstanding that the flush language cites only " §6621(c)(3)." The court reasoned that the flush-language parenthetical more naturally refers only to the definition of "taxable period" in §6621(c)(3)(B), especially as the flush language "does not use the defined term "large corporate underpayment" (or, as possibly adjusted, "large corporate overpayment")."

The district court stated that it was unpersuaded that perfect symmetry between the overpayment and underpayment provisions was intended by Congress. Instead, it appears that, where Congress intended to use "C corporation" in §6621, it did so; and where it used only "corporation," it intended to include all corporations-C corporations, S corporations, and §501(c)(3) corporations together.

Observation: In addition to rejecting similar arguments based on the interpretation of the flush language in §6621(a)(1), the Second and Sixth Circuits also rejected the argument of the taxpayers in *Maimonides Medical Center* and *Detroit Medical Center* that the definition of a "corporation" should generally be read to exclude nonprofit entities.

The district court noted that although the Hospital's policy arguments for a higher interest rate for refunds to nonprofits had merit, those arguments were better aimed at Congress rather than the courts. Hospital appealed the district court decision to the Seventh Circuit.

The Court of Appeals for the Seventh Circuit joined the Second and Sixth Circuits in holding that a non-profit corporation is entitled to the rate of interest due on large corporate underpayments, and not the higher rate that applies to other taxpayers.

The Seventh Circuit characterized Hospital's argument as asserting that "one word means the same thing throughout a statutory section"-an interpretive canon referred to as the "presumption of consistent usage." Essentially, Hospital claimed that because "large corporate underpayment" is defined in §6621(c)(3)(A) as "an underpayment of more than $100,000 by a C corporation" (emphasis added), the lower interest rates in §6621(a) for "corporations" only apply to C corporations as well, thus entitling non-profit corporations like Hospital to the higher rate called for in §6621(a)(1).

The Court found that there were a number of flaws in Hospital's argument. First, it found that §6621(c)(3)(A) does not actually define "corporation" but rather defines "large corporate underpayment," and that "corporate" as an adjective does not dictate the kind of corporation involved. The Court also noted that the presumption of consistent usage has a companion interpretive canon-that different terms used in a statute (corporation vs. C corporation) mean different things.

Second, §6621(c)(3) expressly says that its definitions apply only to subsection (c), and the reference to §6621(c)(3) contained in the flush language of §6621(a)(1) is clearly limited to the definition of "taxable period." The Court found that these provisions were sufficient to overcome the presumption of consistent usage.

Accordingly, the Seventh Circuit affirmed the district court and found that Hospital was not entitled to have the disputed funds returned.

Omoloh, TC Summary Opinion 2017-64.

The Tax Court has upheld IRS's imposition of the early withdrawal tax under §72(t) against a taxpayer who received distributions from his IRA, finding that he failed to show that he was at least age 59-1/2 at the time the distributions were made. Although the taxpayer obtained a birth certificate from Kenya during the course of the trial, the Court questioned its accuracy, noting that the birth certificate was contrary to all other documentation, including his driver's license and certificate of naturalization, as well as his own representations made before trial. The Court also upheld IRS's imposition of an accuracy-related penalty.

§72(t) imposes an additional 10% "early withdrawal" tax on distributions from qualified retirement plans that are taken before the individual reaches age 59-1/2, unless the distribution falls within a statutory exception. A qualified retirement plan includes an IRA. (§408(a), §4974(c)(4))

A 20% accuracy-related penalty under §6662(a) is imposed against any portion of an underpayment of tax that is attributable to a substantial understatement of income tax. (§6662(b)(2); §6662(d)) An understatement of tax is substantial if it exceeds the greater of $5,000 or 10% of the tax required to be shown on the taxpayer's return. (§6662(d)(1)) However, the accuracy-related penalty does not apply to any portion of an underpayment if it is shown that the taxpayer acted with reasonable cause and in good faith. (§6664(c))

Wilfred Omoloh was born in the Republic of Kenya and became a naturalized citizen of the U.S. in 1997. In 2010, Omoloh received distributions totaling $35,000 from an IRA that he maintained at Bank of America, but he did not include the distributions on his 2010 income tax return, nor did he reflect the additional tax imposed by §72(t) for premature withdrawals.

IRS determined that the distributions were includable in Omoloh's income, that the §72(t) additional tax applied with respect to the distributions, and that a §6662(a) penalty applied because the underpayment on Omoloh's return constituted a substantial understatement of income tax. Omoloh has since conceded that the distributions were includable in income.

In preliminary proceedings before trial, Omoloh represented on the record that he was born on October 1, 1951-which would make him younger than 59-1/2 at the time of the distribution and thus subject to the §72(t) additional tax. He subsequently "corrected" his representation to claim October 1, 1950, as his date of birth, such that the §72(t) tax would not apply.

Omoloh's driver's license showed his date of birth as October 1, 1952, as did his certificate of naturalization, other immigration-related documents spanning a period of over 15 years, his college transcript and a court petition for a name change. His recently acquired birth certificate, however, reflecting information he apparently provided to the issuing agency in Kenya, showed his date of birth as October 1, 1950.

The Tax Court noted that the abovementioned documentation and records, as well as prior representations made in proceedings before trial, all suggested that Omoloh was not older than 59-1/2 years of age at the time the distributions were made-and that the only document showing otherwise was a newly issued birth certificate, the accuracy of which was questioned by both IRS and the Court. The birth certificate, while authentic, was issued during the pendency of the case and was apparently based on information that Omoloh himself provided to the issuing Kenyan agency. Overall, the Court found that Omoloh failed to show that IRS's imposition of the §72(t) additional tax was erroneous and accordingly upheld it.

The Tax Court also upheld IRS's imposition of an accuracy-related penalty under §6662(a), noting that Omoloh offered no explanation for his failure to include the distributions in income, nor did he persuade the Court that he believed in good faith that he was old enough to avoid the imposition of the §72(t) additional tax.

Ozimkoski, TC Memo 2016-228.

Where the trustee of taxpayer's decedent husband's IRA incorrectly rolled over his IRA to taxpayer's IRA, and then she made distributions from her IRA, including a payment to her stepson in settlement of his challenge to his father's will, the distributions were subject to tax, the §72(t) tax on early IRA distributions, and the accuracy related penalty.

§408(d)(1) provides that, "[e]xcept as otherwise provided in this subsection, any amount paid or distributed out of an individual retirement plan shall be included in gross income by the payee or distributee." §408(d) provides several exceptions to this rule-e.g., for rollover contributions, transfers incident to divorce, and distributions for charitable purposes. (§408(d)(3), §408(d)(6), §408(d)(8))

Generally, amounts distributed from an IRA are includible in gross income as provided in §72. (§408(d)(1)) §72(t)(1) provides for a 10% additional tax on an early distribution from a qualified retirement plan unless the distribution falls within a statutory exception. §72(t)(2)(A)(ii) provides that distributions "made to a beneficiary (or to the estate of the employee) on or after the death of the employee" are not subject to the 10% additional tax.

§6662(a) and §6662(b)(2) authorize a 20% penalty on the portion of an underpayment of income tax attributable to a substantial understatement of income tax. No penalty may be imposed under §6662 with respect to any portion of an underpayment upon a showing that the taxpayer acted with reasonable cause and in good faith with respect to that portion. (§6664(c)(1))

The taxpayer, Mrs. Ozimkoski, was born in 1955 and was a Florida resident. Her husband, Thomas Ozimkoski (Husband), died in 2006. At the time of his death, Husband owned a traditional IRA. The case did not indicate who the beneficiary(ies) of the IRA were but did specify that Mrs. Ozimkoski was not a beneficiary. Husband's will left all of his property to Mrs. Ozimkoski.

Before any distribution of the IRA was made, Mr. Ozimkoski, Jr, (Junior), who was Mrs. Ozimkoski's stepson and Husband's son, challenged Husband's will in probate court. Shortly thereafter, Wachovia, the IRA trustee, froze Husband's IRA pending the outcome of the probate litigation.

Junior and Mrs. Ozimkoski reached a settlement agreement regarding the probate litigation; Mrs. Ozimkoski agreed to pay Junior $110,000 as a "net payment free of tax" in return for Junior's release of all claims against her. Mrs. Ozimkoski's attorney represented Mrs. Ozimkoski with respect to this agreement but gave her no tax advice with respect to it.

Thereafter, on July 2, 2008, Wachovia transferred $235,495 from Husband's IRA to Mrs. Ozimkoski's traditional IRA. On July 14, 2008, Mrs. Ozimkoski received distributions totaling $141,997 from her IRA. On July 15, 2008, Mrs. Ozimkoski wrote a personal check for $110,000 to Junior, to make the payment required under the settlement agreement.

In 2009 Wachovia issued a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., with respect to the distributions from Mrs. Ozimkoski's IRA for 2008. The distribution code 1 on the Form 1099-R represented that the distributions were early distributions with no known exception because Mrs. Ozimkoski had not reached the age of 59-1/2 in 2008.

Mrs. Ozimkoski's 2008 income tax return did not report the IRA distribution from her IRA as income for 2008. IRA issued a notice of deficiency for the income tax, §72(t) tax and the accuracy-related penalty.

The Court found that $141,997 distributions from her IRA were taxable to Mrs. Ozimkoski.

The Court said that, under Florida law, Wachovia should have distributed the IRA assets to Husband's estate. It also said that, although Wachovia incorrectly rolled over Husband's IRA to Mrs. Ozimkoski's IRA, the Court had no jurisdiction to unwind that transaction and had to decide Mrs. Ozimkoski's tax liability on the basis of Wachovia's erroneous transfer of Husband's IRA assets to her IRA and the subsequent distributions from her IRA. The Court noted that Mrs. Ozimkoski's probate attorney failed to counsel her on the full tax ramifications of paying Junior $110,000 from her own IRA. It said that, while it was sympathetic to Mrs. Ozimkoski's argument, the distributions she received were from her own IRA and therefore were considered taxable income to her for 2008.

The $141,997 distributions were also subject to the 10% tax under §72(t).

The Court noted that it has previously held that a beneficiary loses the entitlement to claim the exception under §72(t)(2)(A)(ii) if the beneficiary rolls over the funds from the deceased spouse's IRA into his or her IRA and thereafter withdraws funds from his or her IRA-see *Gee, (2006) 127 TC 1; Sears, TC Memo 2010-146* -and that that same rule applied here.

The Court held that the accuracy-related penalty only applied to the portion of the IRA distribution that exceeded the $110,000 that Mrs. Ozimkoski paid to Junior.

Mrs. Ozimkoski worked full time but only earned wage income of less than $15,000 for the year in issue. She was not knowledgeable in the areas of probate administration or tax law. She complied with the settlement agreement by taking a distribution from her IRA to make the payment to Junior. Mrs. Ozimkoski had the additional $110,000 in her IRA because Wachovia incorrectly transferred the entirety of Husband's IRA to her instead of to his estate.

In light of all the circumstances, including her experience, knowledge, and education, the Court found that Mrs. Ozimkoski had reasonable cause for, and acted in good faith with respect to, the portion of her underpayment attributable to her failure to include in her taxable income for 2008 the $110,000 she paid to Junior.

Plaza Staffing Services, Inc. v. IRS, Docket No. 6881-12R.

The Tax Court granted summary judgment to IRS and ruled that an employee stock ownership plan (ESOP) was not qualified under §401(a) for its 1999 year and all subsequent years of operation. The plan failed the §410 minimum participation standards as it covered only the sole employee of one corporation belonging to a brother-sister controlled group, and failed to cover the five employees of the other member of the group.

ESOPs are qualified defined contribution plans which are designed to invest primarily in securities of the corporate employer and are subject to the requirements set out in §401(a). ESOPs provide corporate employers and their employees the tax benefits of a qualified plan and, in addition, provide a financing vehicle for the corporation through their ability to borrow to acquire employer securities. ESOPs are tax-exempt entities under §501(a).

In general, to be tax-qualified, a plan must meet the requirements of §401(a). Failure to meet one of the §401(a) requirements disqualifies the plan. Under §401(a)(3), a plan must meet minimum-participation standards set forth in §410. These minimum participation standards provide that a plan does not qualify unless it meets at least one of the following requirements:

1. The plan benefits at least 70% of employees who are not highly compensated employees (§410(b)(1)(A));

2. The plan benefits a percentage of nonhighly compensated employees, which is at least 70% of the percentage of highly compensated employees benefiting under the plan (§410(b)(1)(B)); or

3. The plan meets an average benefit test (§410(b)(1)(C)).

For determining which employees need to be included for the minimum participation tests, all employees of all corporations which are members of a controlled group of corporations are treated as if they are employed by a single employer. (§414(b)) Under §1563(a)(2) and §1653(f)(5), a brother-sister controlled group is a group that consists of two or more corporations if five or fewer persons who are individuals, estates, or trusts own (directly or constructively) stock possessing:

1. At least 80% of the total combined voting power or the total value of shares of all classes of stock of each corporation; and

2. More than 50% of the total combined voting power or the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each person only to the extent it is owned identically as to each corporation.

On November 18, 1998 Dr. Zapolanski acquired all 10,000 shares in Paza from its initial incorporator. A little over a week later, Zapolanski signed a resolution, as the sole director of Paza, establishing an ESOP and appointing himself trustee. He then transferred the Paza stock to the ESOP in exchange for a $10,000 note (the stock itself being the collateral). This made the ESOP Paza's sole shareholder. Zapolanski was the ESOP's sole participant.

On December 1, 1998, Zapolanski, in his capacity as Paza's president, signed a contract with another company named Golden Gate to lease employees. Zapolanski was also the president, secretary, and sole owner of Golden Gate. He received an $83,000 salary from Paza during the 1999 tax and plan year.

The ESOP's plan documents stated that employees employed on December 31, 1998 were immediately eligible participants in the ESOP, but employees hired in 1999 and after had to log one year-a consecutive 12-month period where the employee accrued 1,000 hours of service-before they would be eligible. For the plan year ending in December 1999, Paza made a $12,450 cash contribution to the ESOP and it accrued to the benefit of Zapolanski, the plan's sole shareholder. This released the Paza stock from encumbrance-from there it was allocated to Zapolanski's ESOP account.

During 1999, five Golden Gate employees (if properly included) met the eligibility requirements for the ESOP, yet only Zapolanski was an active participant in the plan.

IRS determined that Paza's ESOP failed to meet the coverage requirements of §401(a)(3) and §410(b), and sent Paza a final nonqualification letter, in which it disqualified the ESOP for the 1999 plan year and all subsequent years.

The primary issue was what group of employees should be considered in determining whether the ESOP met the §410 minimum-participation standards. If only the Paza employees had to be included, Paza would win as Zapolanski was Paza's only employee. But Paza would lose its case if all of Golden Gate's employees had to be included in the employee group.

The ESOP owned 100% of the Paza stock and therefore held 100% of the voting power. But Zapolanski was the ESOP's sole beneficiary, and he therefore had constructive ownership of the stock under §1563(e)(3)(A). As a result, under §1563(a)(2) and §1562(f)(5), Zapolanski owned 100% of the value of the Paza shares, and 100% of the voting power of Paza and Golden Gate. As a result, said the Tax Court, Paza was a controlled group consisting of Paza and Golden Gate, and Golden Gate's employees had to be included in considering whether Paza's ESOP met minimum participation standards.

Zapolanski was the only highly compensated employee at either company. That meant 100% of highly-compensated employees at Paza were benefitting under the ESOP. So, to qualify, the plan would have had to also benefit 70% of the non-highly compensated employees under §410(b)(1)(B). The five qualified employees were non-highly compensated employees qualified for the plan, but they were not participants of the plan. As a result, Tax Court granted IRS's motion for summary judgement and held that the plan did not meet the minimum coverage requirements under §410(b) and could not be treated as a qualified plan under §401(a).

Pizza Pro Equipment Leasing, Inc., (2016) 147 TC No. 14).

A defined benefit pension plan with a normal retirement age set at age 45 did not properly calculate its deductible contributions to that plan under the rule that applies where the retirement benefit under a plan begins before age 62. It thus was liable for the tax that applies to nondeductible contributions.

Subject to certain limits under §415, an employer can generally deduct its timely paid contributions to a qualified plan. (§404(a)) §404(j)(1)(A) provides that in computing the amount of an allowable deduction in the case of a defined benefit plan, any benefits for any year in excess of any limitation on such benefits under §415 for such year are not taken into account.

Under §415(b)(2)(A), a benefit exceeds the limitation if, when expressed as an annual benefit, that benefit is greater than the lesser of $160,000 (adjusted annually for cost of living increases under §415(d); $210,000 for 2016) or 100% of the plan participant's average compensation for his high three years.

§415(b)(2)(C) provides that if the retirement benefit under a plan begins before age 62, the $160,000 limitation should be reduced "so that such limitation (as so reduced) equals an annual benefit (beginning when such retirement income benefit begins) which is equivalent to a $160,000 annual benefit beginning at age 62."

§4972 provides that if an employer makes a nondeductible contribution to a qualified plan, it is subject to a tax equal to 10% of that amount. Nondeductible contributions are amounts contributed by the employer under the plan for a tax year in excess of the amount deductible for that year, plus the amount of any excess contributions for the preceding tax year. The excise tax is imposed on the excess contribution for the tax year it is made, and for each succeeding year to the extent that the excess is not eliminated. Excess contributions for the year are determined as of the close of the employer's tax year. The tax is reported on Form 5330, Return of Excise Taxes Related to Employee Benefit Plans.

For plan years beginning before 2007, there was an elective exception applicable to defined benefit plans under former §4972(c)(7), however, which reduced the amount of nondeductible contributions for the year: In determining the amount of nondeductible contributions for any tax year, an employer may elect for such year not to take into account any contributions to a defined benefit plan except to the extent that such contributions exceed the full-funding limitation.

Pizza Pro Equipment Leasing, Inc. (Pizza Pro) adopted a defined benefit pension plan (Plan) which was a qualified plan under §401(a) throughout the years at issue (2002-2006). At all relevant times, the Plan had a single participant, Pizza Pro's president, Scott Stevens. The Plan's normal retirement age was set at age 45. The Plan provided that the participant's accrued benefits vested fully at death and were payable as a death benefit to the participant's designated beneficiary.

For the years at issue, IRS claimed that portions of Pizza Pro's contributions to the Plan were nondeductible because the Plan's funding did not fully account for the proper reductions imposed by §415(b)(2)(C) for benefits beginning before age 62.

Pizza Pro never filed any Forms 5330. IRS filed substitute Form 5330 returns on Pizza Pro's behalf for the years at issue and subsequently determined deficiencies in payments of the §4972 excise taxes related to excess funding. Pizza Pro sought relief in the Tax Court.

Pizza Pro contended that the §415(b) limitation on annual benefits for defined benefit plans where the participant's benefits are not forfeited at death need only be discounted for the time value of money-that is, for the appropriate interest rate-between the plan's early retirement age and age 62. On the other hand, IRS argued that the annual benefit limitation must be converted into a lump sum using a factor accounting for both interest and mortality, then discounted for the time value of money to the plan's early retirement age, and then reconverted into an annual benefit using again a factor accounting for both interest and mortality.

The Tax Court found that IRS and not the taxpayer had applied the correct method to reduce the maximum benefits under §415(b)(2)(C) to an actuarially equivalent value for a retirement age before age 62, where the plan did not provide for forfeiture of the participant's benefits at death. As a result, Pizza Pro had made nondeductible contributions to the Plan for the tax years 2002 through 2006 because a portion of the total contribution was in excess of §404 limitations. Accordingly, the plan was overfunded, Pizza Pro's contributions to the plan were partially nondeductible, and Pizza Pro was liable for excise taxes under §4972 unless an exception applied.

The Court also rejected Pizza Pro's argument with respect to the §4972 tax that it had, in effect, made the election under former §4972(c)(7) by virtue of the fact that it did not file Form 5330. It reasoned that a taxpayer cannot claim sufficient intent to make the election without something more concrete to evince such intent than its untimely and self-serving assertion. Pizza Pro's retroactive assertion was especially unconvincing in view of its agreement to pay the income tax deficiencies arising out of IRS's disallowance of a portion of its claimed deductions for contributions to the plan in tax years 2004 and 2005. The Tax Court acknowledged that there was nothing in the regulations or other guidance on how to make the election and that courts had taken various positions as to how elections were made when there was no such guidance. But, it ruled against Pizza Pro, noting that there was a line on Form 5330 for the years at issue, for making the election.

Estate of Nancy Powell, (2017) 148 TC No. 18.

Where a taxpayer transferred cash and securities to a limited partnership shortly before her death in exchange for a 99% interest in the partnership, the Tax Court concluded that her ability, acting with the other partners, to dissolve the partnership was a right "to designate the persons who shall possess or enjoy" the cash and securities transferred "or the income there from," under §2036(a)(2). The Court further held that because her partnership interest was transferred, if at all, less than three years before her death, the value of the cash and securities transferred to the partnership was includible in the value of her gross estate to the extent required by either §2036(a)(2) or §2035(a).

An individual's gross estate includes property he transferred during his life if she retained for life:

a. The possession or enjoyment of the property, or the right to the income from the property (§2036(a)(1)), or

b. The right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income from it. (§2036(a)(2))

These rules do not apply to a transfer that was a bona fide sale for an adequate and full consideration in money or money's worth. (§2036(a))

In addition, an individual who transferred an interest in, or relinquished a power over, any property, within three years of death, must include the value of the property in her gross estate to the extent it would have been included in her gross estate under, among other provisions, §2036, if the interest or relinquished power had been retained. (§2035(a))

Where there has been a transfer of property for insufficient consideration, computing the amount includible in the decedent's estate requires subtracting the value of the consideration received by her from the value of the transferred property as of her death (or alternate valuation date). (§2043(a), Regulation §20.2043-1(a))

On August 8, 2008, Nancy Powell's son, Jeffrey Powell, acting on her behalf, transferred cash and securities to NHP Enterprises LP (NHP), a limited partnership, in exchange for a 99% limited partner interest. On that date, the transferred cash and securities were worth $10 million. NHP had been formed two days earlier, on August 6, 2008, when Jeffrey, as general partner, executed and filed with the Delaware secretary of state a certificate of limited partnership. NHP's limited partnership agreement gives him, as general partner, sole discretion to determine the amount and timing of partnership distributions. That agreement also allows for the partnership's dissolution with the written consent of all partners.

Also on August 8, 2008, Jeffrey, purportedly acting under a power of attorney, transferred Nancy's NHP interest to a charitable lead annuity trust (CLAT), the terms of which provided an annuity to a charitable organization for the rest of Nancy's life. Upon her death, CLAT's corpus was to be divided equally between Nancy's two sons.

Nancy died on August 15, 2008.

IRS, by separate notices of deficiency, determined a deficiency of $5.9 million in the Federal estate tax of the Estate of Nancy Powell (decedent) and a deficiency of nearly $3 million in decedent's Federal gift tax for 2008.

The Tax Court concluded that Nancy's ability, acting with NHP's other partners, to dissolve the partnership was a right "to designate the persons who shall possess or enjoy" the cash and securities transferred to NHP "or the income there from," within the meaning of §2036(a)(2). The Court further held that because Nancy's NHP interest was transferred, if at all, less than three years before her death, the value of the cash and securities transferred to NHP was includible in the value of her gross estate to the extent required by either §2036(a)(2) or §2035(a).

The Court determined that if Nancy retained until her death her rights with regard to the transferred cash and securities, the value of those assets would be includible in the value of her gross estate to the extent required by §2036(a). If, instead, she made a valid gift of her NHP interest before her death, and thus relinquished her retained right to the cash and securities, the value of those assets would still be includible in the value of her gross estate to the extent required by §2035(a).

The Court also held that neither §2036(a)(2) nor §2035(a) (whichever applied) required inclusion in the value of Nancy's gross estate of the full date-of-death value of the cash and securities transferred to NHP. The Court determined that only the excess of that value over the value of the limited partner interest that Nancy received in return was includible in the value of her gross estate under §2043(a). Although the terms of each section, read in isolation, would require that result, those sections must be read in conjunction with §2043(a), which complements the bona fide sale exception to the inclusionary rules provided in §2035 through §2038. If a transfer depletes a decedent's estate to any extent, the bona fide sale exception will generally not apply. But if the decedent receives some consideration, §2043(a) limits the required inclusion to the amount by which the transfer depletes the decedent's estate. Because the estate did not challenge IRS's contention that Jeffrey had no legitimate and significant nontax reason for creating NHP, the transfer of cash and securities to the partnership was "not a bona fide sale for an adequate and full consideration in money or money's worth," regardless of the value of the limited partner interest issued in exchange for those assets. Therefore, §2043(a) limited the amount includible in the value of decedent's gross estate, by reason of §2036(a)(2) (either alone or in conjunction with §2035(a)).

In addition, the Court determined that Jeffrey's transfer of Nancy's NHP interest to the CLAT was either void or revocable under applicable State law (California) because Nancy's power of attorney did not authorize Jeffrey to make gifts in excess of the annual Federal gift tax exclusion. If the gift was void, the value of the limited partner interest on the date of decedent's death would be includible in the value of her gross estate under §2033. If the gift was revocable, that same value would be includible in the value of her gross estate under §2038(a). Consequently, under §2033 or §2038(a), the value of the 99% limited partner interest in NHP, as of the date of Nancy's death, was includible in the value of her gross estate.

Seven Judges joined in an opinion that concurred in result only with the majority opinion. The concurring opinion rejected the majority's reasoning that §2036(a) did not require "the inclusion in the value of decedent's gross estate of the full date-of-death value of the cash and securities," while admitting that the statute, "read in isolation, would require that result." The concurring opinion found no "double inclusion" problem- i.e., including the $10 million in her estate via §2036(a)(2) and again via her partnership interest, which would be separately includible as property of the estate under §2033. Rather it found that the decedent's supposed partnership interest obviously had no value apart from the cash and securities that she allegedly contributed to the partnership. The partnership was an empty box into which the $10 million was notionally placed. Once that $10 million is included in her gross estate under §2036(a)(2), it seemed perfectly reasonable to regard the partnership interest as having no distinct value because it was an alter ego for the $10 million of cash and securities. The concurring opinion concluded that there was no double-counting problem if §2036(a)(2) was read as it always had been read, to disregard a "transfer with a string" and include in the decedent's estate what she held before the purported transfer-the $10 million in cash and securities.

Estate of Sommers, (2017) 149 TC No. 8.

The Tax Court has denied an estate an estate tax deduction for gift tax that was unpaid on the date of death. The Court arrived at that conclusion based on the fact that the gift in question was a net gift, such that while the estate was ultimately technically liable for the gift tax, that gift tax was subject to reimbursement by the donee.

A "net gift" is a gift with respect to which the donee pays any gift tax.

§2053(a) allows a deduction from the gross estate for funeral and administration expenses, claims against the estate, and indebtedness in respect of property included in the decedent's gross estate. The regulations confirm that gift taxes owed by a decedent's estate at his or her death are generally deductible. (Regulation §20.2053-6(d))

Mr. Sommers made a net gift to his niece; at the date of his death, the gift tax on that gift had not been paid by the niece. His estate sought to take an estate tax deduction, under §2053, for the unpaid gift tax.

The Tax Court denied the deduction for the unpaid gift tax.

The estate argued that the gift tax owed by decedent on his gift and unpaid at his death is deductible under the plain terms of Regulation §20.2053-6(d). The estate reasoned that the payment of the gift tax by his niece rather than by the estate does not affect the estate's entitlement to the claimed deduction because §2502(c) "imposes the obligation to pay gift tax on the donor and the obligation remains on, and is deemed owed and paid by, the donor, even in a 'net' gift setting."

The Court said that longstanding precedent establishes that a claim against an estate is deductible in computing estate tax liability only to the extent that it exceeds any right to reimbursement to which its payment would give rise. Here, the niece was contractually obligated to pay the gift tax, which would have entitled the estate to a reimbursement of any of the gift taxes that it paid.

Summers, TC Memo 2017-125.

Where a young couple negotiated divorce terms without being represented by counsel, and the husband took a distribution from his IRA and gave half of it to the wife before the divorce was finalized-which resulted in the divorce decree providing that neither party had an IRA-the husband was liable for the penalty for an early distribution from a retirement plan, with respect to both his and his wife's shares of the IRA distribution.

§72(t)(1) imposes a 10% penalty on early distributions from qualified retirement plans. For purposes of this rule, a qualified retirement plan includes an IRA. (§408(a), §4974(c)(4)) §72(t)(2) lists various types of distributions that are excepted from this penalty. One such exception, in §72(t)(2)(C), applies to a distribution that is made "to an alternate payee pursuant to a qualified domestic relations order (within the meaning of §414(p)(1))." An "alternate payee" is defined in §414(p)(8) as "any spouse, former spouse, child or other dependent of a participant who is recognized by a domestic relations order as having a right to receive all, or a portion of, the benefits payable under a plan with respect to such participant." §414(p)(1)(B) defines a "domestic relations order" as a "judgment, decree, or order" relating to "the provision of child support, alimony payments, or marital property rights" that "is made pursuant to a State domestic relations law."

However, §72(t)(3)(A) provides that §72(t)(2)(C) does not apply to distributions from IRAs.

The taxpayer, Jeremy Summers, age 35, had an IRA. He and his wife, Karie, decided to divorce and to do so without involving lawyers. The couple agreed that they should split the IRA 50-50. Jeremy's petition for divorce accordingly requested that "the proceeds of IRA should be divided 50% to Petitioner and 50% to Respondent."

Jeremy withdrew the total proceeds of the IRA, and deposited them in a checking account that he and Karie jointly held. The next day he wrote two checks whose amounts totaled half the amount he received, one to pay off one of Karie's debts and one to Karie.

Thereafter, an Arizona court entered a consent decree of dissolution of marriage. This decree incorporated substantially all of the agreements set forth in Jeremy's petition. However, since he and Karie had already divided up the IRA, the decree provided, in an attached exhibit captioned "Property and Debts," that "neither party has a retirement, pension, deferred compensation, §401(k) Plan and/or benefits."

The parties agreed that Jeremy was liable for the 10% penalty on the portion of the IRA proceeds that he did not pass on to Karie. The only issue was whether Jeremy was liable for the penalty with respect to the portion that he did pass on to Karie.

The Court held that Jeremy as liable for the penalty with respect to the portion that he passed on to Karie.

IRS "readily agree[d]" that the transaction could likely have been organized so as to entitle Jeremy to a §72(t)(2)(C) exception for Karie's 50% share. But, IRS made two arguments that, because of the form of the transactions, Jeremy was not so entitled, and the Court agreed.

First, the IRA distribution was made directly to Jeremy, and he deposited the check into a bank account that he and Karie jointly held. He subsequently transferred, to Karie or for her benefit, an amount equal to half of the proceeds. But while she ultimately received those proceeds, the distribution itself was made to Jeremy, not, as required by §414(p)(8), to "a former spouse...who is recognized by a domestic relations order as having a right to receive" a share of the proceeds.

Second, the distribution was not made "pursuant to a qualified domestic relations order." Although Jeremy's petition for dissolution of marriage requested a 50-50 division of the IRA, any judicial action on that request was pretermitted by his well-intentioned decision to divide the IRA with Karie a month before the divorce decree was entered. That decree accordingly recited that "neither party has a retirement, pension, deferred compensation, §401(k) Plan and/or benefits." The IRA distribution was not made "pursuant to" that order or any other judicial decree.

The Court then cited several cases in which it had held that a taxpayer must strictly comply with the requirements of §72(t)(2)(C) in order to be entitled to the exception it provides.

Observation: Neither the parties nor the Court made any mention of §72(t)(3)(A) in this case. And, there is no indication in the case why IRS did not argue that §72(t)(3)(A) was sufficient grounds to defeat Jeremy's claim that he qualified for relief under §72(t)(2)(C). Thus, while this case would not seem to provide much value to practitioners with respect to cases involving IRAs, it does provide value with respect to distributions from other qualified retirement plans.

True the Vote Inc. et al, (CA Dist Col 8/5/2016) 118 AFTR 2d 2016-5367, cert denied 2/21/2017.

The Supreme Court has declined to review a decision of the Court of Appeals for the District of Columbia that denied politically conservative groups so-called Bivens relief on the basis that IRS employees violated their constitutional rights by singling them out for unnecessary scrutiny and delaying consideration of their applications for tax-exempt status. The DC Circuit had concluded that, in light of the comprehensive remedial scheme set out in the Code, Bivens relief is unavailable.

Under §501(c)(4), civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare are exempt from income taxation if no part of their earnings inures to the benefit of any private shareholder or individual and no substantial part of the organization's activities consists of providing commercial-type insurance. These organizations may engage in political campaign activities on behalf of or in opposition to candidates for public office. However, in order to retain its tax-exempt status, an organization must ensure that political campaign activities do not constitute its "primary" activity. (Regulation §1.501(c)(4)-1(a)(2)(i); Revenue Ruling 81-95, 1981-1 CB 332)

On May 14, 2013, the Treasury Inspector General for Tax Administration issued a report entitled "Inappropriate Criteria Were Used to Identify Tax-Exempt Applications for Review," which stated, "the criteria developed by the [IRS] Determinations Unit gives the appearance that the IRS is not impartial in conducting its mission. The criteria focused narrowly on the names and policy positions of organizations instead of tax-exempt laws and Treasury regulations."

Returns and return information are confidential, and may not be disclosed except as authorized under the Code. (§6103(a)) "Return information" is defined broadly to include "any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to a determination of the existence, or possible existence" of a taxpayer's liability under the Code. (§6103(b)(2)(A)) Under one of the exceptions to §6103(a), inspection by or disclosure to officers and employees of the Department of the Treasury whose official duties require such inspection or disclosure for tax administration purposes, is permitted. (§6103(h)(1)) §7431 provides damages for violations of §6103.

Federal courts, pursuant to Article III of the Constitution, have no jurisdiction to act unless there is "a case or controversy." Where a case once posed a live controversy when filed, the mootness doctrine requires the Court to refrain from deciding it if events have so transpired that the decision will neither presently affect the parties' rights nor have a more-than-speculative chance of affecting them in the future. See, e.g., *Clarke v. United States,* (CA Dist Col 1990) 915 F.2d 699.

The taxpayers in the case were two sets of politically conservative groups, True the Vote, Inc. (True) and Linchpins of Liberty (Linchpins), that applied for tax-exempt status under §501(c)(4) as social welfare organizations.

Each taxpayer brought a suit in district court in which it sought so-called Bivens relief (i.e., monetary claims against IRS employees in their individual capacities), a declaratory judgment that an "IRS targeting scheme" violated its First Amendment rights and injunctive relief to prevent additional violations, and civil damages for IRS violations of §6103. (True the Vote, Inc., (DC Dist Col 2014) 114 AFTR 2d 2014-6381; Linchpins of Liberty, (DC Dist Col 2014) 114 AFTR 2d 2014-6391)

Observation: The two district court cases were not officially consolidated at the Circuit Court, but the issues were the same and therefore there was one opinion. The Circuit Court only discussed the facts in Linchpins.

The taxpayers in Linchpins included two parties whose application for tax-exempt status had not been acted upon as of the date when the Linchpins complaint had been filed.

IRS contended, and the district court agreed, that taxpayers' claims became moot because IRS had stopped using its admittedly improper discriminatory criteria and handling of applications by taxpayers with politically disfavored names. And so the district court ruled that it did not have jurisdiction to grant the declaratory or injunctive relief sought by the taxpayers.

As to the claim for damages for IRS's violation of §6103, the district court also sided with IRS. It held that the taxpayer's real bone of contention was that IRS allegedly demanded information that was not necessary for determining the taxpayer's tax-exempt status, and then inspected it. The court said that, although True was upset about IRS's inspection of its tax return information, it was actually IRS's alleged unconstitutional conduct in acquiring that information that formed the basis of the taxpayer's complaint. But, it said, §6103 is silent as to how tax return information can be acquired. Even assuming that IRS improperly acquired the taxpayer's tax return information that does not compel a finding that such information was improperly inspected.

The district court also denied the claim for Bivens relief, finding that DC Circuit precedent foreclosed any such action against IRS employees in their individual capacities in light of the "comprehensive remedial scheme" set out in the Code. (*Kim v. U.S.,* (CA DC 2011) 107 AFTR 2d 2011-590)

The Court of Appeals for the District of Columbia affirmed in part, and reversed and remanded in part, the district court's decision.

The DC Circuit affirmed the district court's holding that the taxpayers could not receive damages for IRS's violations of §6103. The Court, citing *NorCal Tea Party Patriots* (DC OH 2014) 114 AFTR 2d 2014-5358, said that, in order for the taxpayers to prevail on their §6103 argument, they had to establish that IRS officials who inspected or disclosed the return information did so knowing that the information was not necessary for tax administration purposes, regardless of whether the IRS officials who requested the information knew or believed it was necessary for the §501(c)(4) application. And, it said that the taxpayers failed at this because their complaint made only conclusory allegations about this issue. Accordingly, since no §6103 violation was shown, the taxpayers were not entitled to damages. (For more details on the DC Circuit's opinion.

The Court also affirmed the denial of Bivens relief, noting that, as it held in Kim, the "comprehensive remedial scheme" in the Code precludes any Bivens remedy against IRS employees in their individual capacities.

The Court reversed, however, the district court's holding that the claim was moot, finding that IRS failed to meet the "voluntary cessation" doctrine requirements. IRS claimed that no more than two applications for exemption remained pending with it on the day of the Circuit Court pleading, but the Court found that "near cessation" was insufficient to meet IRS's burden.

On February 21, 2017, the Supreme Court refused to review the DC Circuit's decision. Accordingly, that decision is now final.

U.S. v. McNicol, (CA 1 7/15/2016) 118 AFTR 2d 2016-5150, cert denied 1/9/2017.

The Supreme Court has declined to review a decision of the Court of Appeals for the First Circuit which found that a surviving spouse who served as executrix of her deceased husband's estate was personally liable for the estate's unpaid taxes in an amount equal to the value of the assets that she transferred to herself instead of using to pay the government's priority tax claim. The record established her liability under the federal priority statute-specifically, that she distributed assets of the estate, that the estate was insolvent, and that she was aware of the unpaid taxes at the time of the distribution.

The federal priority statute, 31 USC 3713, directs that the government be paid first when the estate of a deceased debtor has insufficient assets to pay all of its debts. Personal liability may be imposed upon a fiduciary of an estate who fails to honor a priority claim of the government. (31 USC 3713(b))

For personal liability to attach, the government must establish that:

1. The fiduciary distributed assets of the estate;

2. The estate was insolvent at the time of the distribution or the distribution rendered the estate insolvent (i.e., with liabilities in excess of assets); and

3. The distribution took place after the fiduciary had actual or constructive knowledge of the liability for unpaid taxes. (*Coppola,* (CA 2 1996) 77 AFTR 2d 96-2477)

Robert Reitano died in July of 2002, survived by his wife (appellant Marci McNicol; executrix of the estate) and four minor children. At the time of his death, Mr. Reitano owed over $340,000 in unpaid federal income tax liabilities. Since these liabilities exceeded the value of his estate, the estate was insolvent.

The assets of the estate consisted almost entirely of stock in two corporations, one 100% owned by the estate, the other 50% owned by the estate and 50% owned by Ms. McNicol. Each corporation owned a fishing vessel as its sole asset. Over the next year, Ms. McNicol transferred the estate-owned shares in both corporations to herself for no consideration. She was admittedly aware of Mr. Reitano's unpaid tax debts at that time.

Later in 2003, IRS completed its assessment of taxes, penalties, and interest owed by Mr. Reitano's estate, which totaled $342,539. IRS contacted Ms. McNicol about this debt and, in October of 2003, formally submitted a probate claim. Nothing was paid, and IRS eventually served Ms. McNicol with a formal notice of potential liability under the federal priority statute (31 USC 3713(b)) and brought suit.

The district court held on summary judgment that she was liable under the federal priority statute up to the value of the transferred assets and entered judgment against her personally for $125,938. This amount reflected the selling price of both vessels, less a lien against one. Ms. McNicol appealed.

The First Circuit found that Ms. McNicol did not comply with the district court's rules in connection with a motion for summary judgment-namely, she failed to submit a "concise statement of the material facts" either in support of her motion or in opposition to IRS's motion-and that the consequences of such failures were that the facts set out in IRS's statement were deemed admitted.

The Court then turned to Ms. McNicol's liability under 31 USC 3713(b) and concluded that the district court's determination was proper. The acknowledged facts unambiguously showed that she effected asset transfers by distributing "virtually all" of the assets of Mr. Reitano's estate to herself, that the estate was insolvent at the time of the transfers because its tax liabilities far exceeded the value of its assets, and that she was aware of the unpaid tax liabilities at the time of the transfers.

Ms. McNicol argued on appeal for an "equitable exception" to the federal priority statute-that certain types of expenses associated with administering an estate may be entitled to precedence over the tax liabilities, and that she used the transferred assets to pay such expenses. However, while there are certain exceptions to the government's priority (e.g., funeral costs), the summary judgment record showed that she did not transfer the stock to herself for purposes of paying the estate's administrative expenses but rather because (as per the deemed admitted facts set out by IRS) she "wanted to maintain the lucrative income that the vessels had been generating." Ms. McNicol also failed to adequately substantiate that any such administrative expenses were actually paid.

The Supreme Court has declined to review the case. Accordingly, the First Circuit's decision is now final.

Estate of Sower, (2017) 149 TC No. 11

The Tax Court has rejected a series of arguments made by the estate of the second spouse to die, to the effect that IRS be precluded from auditing the estate tax return of the first spouse to die for purposes of determining the estate tax of the second spouse, where the first spouse made the estate tax portability election.

§2010 provides a "unified credit against estate tax." This credit effectively reduces the value of the estate for the purpose of calculating the tax. It includes both the basic exclusion amount and "in the case of a surviving spouse, the deceased spousal unused exclusion amount." (§2010(c)(2))

The DSUE is the lesser of the basic exclusion amount or "the excess of the applicable exclusion amount of the last such deceased spouse of such surviving spouse, over the amount with respect to which the tentative tax is determined under §2001(b)(1) on the estate of such deceased spouse." (§2010(c)(4)) If the estate of the predeceased spouse elects portability, the later-deceased spouse's estate can effectively reduce its taxable estate by the amount by which the basic exclusion exceeds the sum of predeceased spouse's taxable estate and adjusted taxable gifts. (§2010(c)(5)(A), §2001(b)(1))

§2010(c)(5)(B) gives IRS the power to examine the estate tax return of the predeceased spouse to determine the DSUE amount, regardless of whether the period of limitations on assessment has expired for the predeceased spouse's estate.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, which created §2010(c)(5)(B), provided that "amendments made by this section shall apply to estates of decedents dying and gifts made after December 31, 2010."

For the years at issue in this case, temporary regulations restated IRS's power to examine the return of the predeceased spouse to determine the proper DSUE amount. (Regulation §20.2010-2T(d); Regulation §20.2010-3T(d))

§7602 gives IRS broad discretion to examine a range of materials to "ascertain...the correctness of any return." Under §7602(a)(1), Congress gave IRS specific authority "to examine any books, papers, records, or other data which may be relevant or material."

Under §7121(a), IRS is explicitly authorized to enter into written agreements "with any person relating to the liability of such person." Agreements under §7121 are final. IRS cannot reopen a matter for which a closing agreement has been executed unless there is a "showing of fraud or malfeasance, or misrepresentation of a material fact." (§7121(b)) Under the applicable regulations, only the prescribed forms, Form 866, Agreement as to Final Determination of Tax Liability, and Form 906, Closing Agreement on Final Determination Covering Specific Matters, qualify as closing agreements. (Regulation §601.202(b); Regulation §301.7121-1(d)(1))

To prevail on a claim of equitable estoppel against IRS, a taxpayer must show four essential elements: (1) there must be a false representation or wrongful misleading silence; (2) the error must be in a statement of fact and not in an opinion or a statement of law; (3) the person claiming the benefits of estoppel must be ignorant of the true facts; and (4) he or she must be adversely affected by the acts or statements of the person against whom an estoppel is claimed. (Estate of Emerson, (1977) 67 TC 612)

§7605(b) provides that "no taxpayer shall be subjected to unnecessary examination or investigation, and only one inspection of a taxpayer's books of account shall be made for each tax year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary."

Frank and Minnie Sower were husband and wife. Frank died in 2012; his estate elected portability.

IRS issued Letter 627, Estate Tax Closing Document, to Frank's estate. The Letter 627 showed no estate tax liability for Frank's estate. The Letter 627 also stated that the return had been accepted as filed and further stated: "IRS will not reopen or examine this return unless...notified of changes to the return or there is: (1) evidence of fraud, malfeasance, collusion, concealment or misrepresentation of a material fact; (2) a clearly defined substantial error based upon established Internal Revenue Service position; or (3) a serious administrative error."

Minnie died in 2013. IRS conducted an audit of Minnie's estate tax return. Strictly for purposes of determining Minnie's estate tax, IRS reviewed Frank's estate tax return, determined that the DSUE amount on that return was overstated, and, as a result, determined that there was a deficiency on Minnie's estate tax return.

Minnie's estate then made a series of arguments that IRS should not be allowed to adjust the DSUE amount.

IRS rejects all of taxpayer's arguments. IRS rejected all of the arguments that Minnie's estate made. Minnie's estate advanced two arguments regarding why the Letter 627 should bar IRS's examination of the return of Frank's estate to determine the DSUE available to Minnie's estate. Minnie's estate asserted that the Court and IRS should treat the Estate Tax Closing Document as a closing agreement under §7121. The estate also argued that IRS was estopped from examining the return of Frank's estate by the text of the Letter 627.

The Court said that in extraordinarily rare cases, courts have bound IRS to an agreement in the absence of a properly executed Form 866 or Form 906. In Treaty Pines Invs. Partnership (CA 5 1992) 70 AFTR 2d 92-5435, the Court of Appeals for the Fifth Circuit held that "a tax settlement agreement is binding even if it consists only of letters of offer and acceptance; no formal stipulation of settlement, filed decision document, or closing agreement is necessary." In that case, there had been a period of negotiation between the parties and a clear exchange of offer and acceptance.

Here, no such negotiation took place. IRS sent the initial Estate Tax Closing Document, and neither party alleged any facts that suggest that the estate and IRS engaged in any further communication until after the audit of the return filed by Minnie's estate. There simply was no agreement between Frank's estate and IRS. There was no evidence of a closing agreement. And the estate tax closing document did not bear the hallmarks of any other kind of agreement, i.e., negotiation followed by offer and acceptance.

The Court also said that Minnie's estate established none of the equitable estoppel elements. The estate did not establish a "false representation or wrongful misleading silence" on the part of IRS. The issues in this case were questions of law and not fact, and both parties were aware of the relevant facts in this case at the relevant times. Finally, Minnie's estate did not show that it was adversely affected in a manner that justified estopping IRS.

Minnie's estate also argued that IRS's examination of Frank's return was an improper second examination.

The Court said that there was no second examination. It said that it had previously held that IRS does not conduct a second examination when it does not obtain any new information. See, e.g., *Ballantine*, (1980) 74 TC 516. IRS did not request additional information from Frank's estate, and consequently there was no second examination.

The Court also said that, even if IRS had conducted a second examination of the return for Frank's estate, it would not have violated §7605(b) as to Minnie's estate. The Tax Court and others have found that only the examined party is protected from second examinations. Here, the party that was claiming protection against the effects of a purported "second examination" (i.e., Minnie's estate) was not the party that underwent the examination (i.e., Frank's estate).
In addition, the Court held that:

1. The applicable regulations relating to §2010 do not prohibit IRS from examining the predeceased spouse's return.

2. The effective date of §2010(c)(5)(B) does not preclude IRS from adjusting the DSUE amount by gifts given before December 31, 2010, when the DSUE amount affects an estate tax return for a decedent dying after December 31, 2010.

3. IRS's application of §2010(c)(5)(B) did not frustrate congressional intent with respect to portability.

4. The period of limitations on assessment of tax for the estate of the predeceased spouse is not implicated if IRS does not determine an estate tax deficiency for the estate of the predeceased spouse.

Wu v. U.S., (CA 7 08/29/2016) 118 AFTR 2d 2016-5586, cert denied 3/6/2017.

The Supreme Court has declined to review a decision of the Court of Appeals for the Seventh Circuit, which held that taxpayers who made excess contributions to their IRAs in 2007, then withdrew the excess contributions and their corresponding earnings in March of 2010 upon realizing the mistake, could not avoid the tax on excess contributions for the 2009 tax year. The 7th Circuit found that §408(d)(4) only applies to excess contributions that are paid into an IRA during a tax year and distributed by the filing deadline for that same tax year.

An individual who contributes more to an IRA than he's entitled to deduct must pay a 6% "excess contribution" tax under §4973(a) on that excess for each year that the excess remains in the IRA.

An "excess contribution" to an IRA is the sum of:

1. The excess of the amount contributed for the tax year (other than a contribution to a Roth IRA or a rollover contribution), over the amount allowable as a deduction for the contribution, plus

2. Any excess contribution for the preceding tax year, reduced by the sum of taxable distributions for the tax year, distributions for the tax year of excess contributions after the due date of the return, and the excess (if any) of the maximum amount allowable as a deduction for the tax year, over the amount contributed to the IRA for the tax year (without regard to any deduction for a preceding year's excess contribution). (§4973(b))

However, under §4973(b)(2), any contribution that is withdrawn from an IRA in a distribution to which §408(d)(4) applies is treated as an amount not contributed (i.e., there is no excess contribution tax for that year).

§408(d)(1) provides that any amount paid or distributed out of an individual retirement plan is included in the gross income of the payee or distributee. However, §408(d)(1) does not apply to contributions that are paid during a tax year to an individual retirement account if they are returned, with any income earned thereon, before the filing due date for that year (among other requirements). (§408(d)(4))

Michael and Christine Wu each had an IRA to which each contributed $200,000 after selling their home in 2007. For that tax year, the maximum allowable deduction for IRA contributions was $4,000. In March 2010, the Wus realized their mistake and withdrew from their IRAs the excess contributions and corresponding earnings.

They jointly notified IRS about the excess contributions and asked that the resulting taxes under §4973(a) for 2007 through 2009 be waived. IRS gave different answers to the couple: Michael received a letter concerning his inquiry saying that taxes had been assessed for each year; and Christine received a letter dated July 19, 2010 telling her that her "claim for credit" had been disallowed, that she too had been assessed taxes on her excess contributions, and that she could appeal the decision disallowing her claim.

Afterward, the Wus promptly paid the taxes plus penalties. In February 2012, each filed a refund claim for the taxes attributable to 2009, based on the assertion that they had withdrawn the excess contributions and corresponding earnings for that year before the filing deadline. In April 2013, IRS's Appeals Office rejected this contention in a letter addressed to both Michael and Christine. According to the Appeals Office, the filing deadline for a particular tax year is relevant only to events occurring during that tax year-so in this case, no taxes would have been incurred for 2009 if the excess contributions had been made in that year and distributed before the April 2010 filing deadline, but since the excess contributions were made in 2007, the 2010 distributions did not correct the error.

Two months later, in June 2013, the Appeals Office sent a second letter, this one addressed only to Christine, upholding IRS's previous rejection of her "claim for credit." She was told that she could sue for a refund in federal court so long as she did so within two years of the July 19, 2010 letter-a deadline that had long since passed.

The Wus jointly sued for refunds in May 2014, citing §4973(b), which provides that IRA contributions made but then distributed under §408(d)(4) "shall be treated as an amount not contributed." §408(d)(4), in turn, says that a "distribution of any contribution paid during a taxable year" will not count as gross income (under §408(d)(1)) if that distribution "is received on or before the day prescribed by law (including extensions of time) for filing such individual's return for such taxable year." The Wus argued that this language means that excess contributions, for whatever year added to an IRA, are exempt from the annual tax on excess contributions in a later tax year if a distribution is made during, or before a return is due for, that later tax year.

On the government's motion, the district court dismissed the action, agreeing with the government's position that Michael did not state a claim and that it lacked subject-matter jurisdiction over Christine's claim. The court accepted the government's reading of §408(d)(4) as covering only those distributions made before the return deadline of the tax year when the excess contribution was made, and not withdrawals of contributions made in earlier tax years. As for Christine, the district court found that she had not filed suit within two years of receiving the IRS's July 19, 2010 disallowance letter, as required under §6532(a)(1), and that it accordingly lacked jurisdiction over her claim. In the alternative, the court also found that Christine did not state a claim for the same reasoning that applied to Michael-essentially, that their reading of §408(d)(4) was incorrect.

The Court of Appeals for the Seventh Circuit first found that Christine's claim was for waiver of a penalty and not refund of assessed taxes, so dismissal based on timeliness was improper. Christine, like Michael, first claimed a refund of the 2009 taxes in February 2012 and then brought this action barely a year after the Appeals Office finally disallowed that claim. However, the 7th Circuit then found that the Wus' interpretation of §408(d)(4) was incorrect and affirmed the dismissal for that reason. The Court also found the Wus' citation to §4973(b) was misplaced because that provision concerns treating amounts as if they had never been contributed-which is not the relief that the Wus sought.

On March 6, 2017, the Supreme Court refused to review the Seventh Circuit's decision. Accordingly, that decision is now final.

T.D. 9811, 01/18/2017; Regulation §1.48-12, Regulation §1.83-4, Regulation §1.179-4, Regulation §1.179-6, Regulation §1.197-2, Regulation §1.267(d)-1, Regulation §1.267(d)-2, Regulation §1.273-1, Regulation §1.306-3, Regulation §1.306-4, Regulation §1.336-1, Regulation §1.336-5, Regulation §1.355-6, Regulation §1.382-9, Regulation §1.421-2, Regulation §1.423-2, Regulation §1.424-1, Regulation §1.467-7, Regulation §1.467-9, Regulation §1.617-3, Regulation §1.617-4, Regulation §1.617-5, Regulation §1.684-3, Regulation §1.684-5, Regulation §1.691(a)-3, Regulation §1.742-1, Regulation §1.743-1,

Regulation §1.755-1, Regulation §1.995-4, Regulation §1.1001-1, Regulation §1.1014-1, Regulation §1.1014-4, Regulation §1.1014-5, Regulation §1.1223-1, Regulation §1.1245-2, Regulation §1.1245-3, Regulation §1.1245-4, Regulation §1.1250-4, Regulation §1.1254-2, Regulation §1.1254-3, Regulation §1.1254-4, Regulation §1.1254-5, Regulation §1.1254-6, Regulation §1.1296-1, Regulation §1.1312-7.

Final regulations that incorporate the modified carryover basis rules under now-repealed §1022 into a number of existing regulations that involve the basis of property acquired from a decedent. IRS noted that, while former §1022 was applicable only to decedents dying in 2010, basis determined under former §1022 will continue to be relevant until all property, the basis of which is determined under that section, has been sold or otherwise disposed of.

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16), the estate tax was to have been repealed for individuals dying in 2010, and the rules allowing a step-up in basis for property acquired from a decedent were to have been replaced with a modified carryover basis regime. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act, P.L. 111-312) restored the estate tax for individuals dying in 2010 with a $5 million per-person exemption and a maximum rate of 35%. It also repealed the modified carryover basis rules for property acquired from a decedent who died in 2010. However, §301(c) of the 2010 Tax Relief Act allows estates of individuals dying in 2010 to elect zero estate tax and the modified carryover basis rules that would have applied before they were repealed (a Section 1022 election).

Generally, under §1014(a), the basis of property in the hands of a person acquiring the property from a decedent is the fair market value (FMV) of the property at the date of the decedent's death. However, if the decedent died in 2010 and the decedent's executor made the Section 1022 Election, then the basis of property in the hands of a person acquiring the property from that decedent is governed by former §1022 and not by §1014.

Former §1022(a)(1) generally provides that property acquired from the decedent (within the meaning of former §1022(e)) is treated as having been transferred by gift. If the decedent's basis is less than or equal to the property's fair market value (FMV) determined as of the decedent's date of death, the recipient's basis is the decedent's basis. (Former §1022(a)(2)(A)) If the decedent's basis is greater than that FMV, the recipient's basis is limited to that FMV. (Former §1022(a)(2)(B))

Former §1022(b) and §1022(c) allow the executor to allocate additional basis, up to statutory dollar amounts (Basis Increase), to increase the basis of certain assets that both are acquired from the decedent and are owned by the decedent at death (within the meaning of former §1022(d)). If the property is acquired from and owned by the decedent, and if the decedent's basis in the property is less than the property's FMV on the decedent's date of death, then the executor generally may allocate Basis Increase to the property, provided that the property's total basis may not exceed the property's FMV on the date of death.

Although former §1022 applies only to decedents dying in calendar year 2010, basis determined pursuant to that section will continue to be relevant until all of the property whose basis is determined under that section has been sold or otherwise disposed of. Accordingly, the existing regulations need to be updated to incorporate appropriate references to basis determined under former §1022.

In May of 2015, IRS issued proposed regulations that would incorporate into the existing regulations, as appropriate, references to former §1022 to ensure that references to basis also include basis as determined under former §1022. Some changes in the proposed regulations involve simply inserting the words "or section 1022" or similar words to that effect, others require the insertion of a new sentence or an example to expressly address the applicability of former §1022, and a few require the inclusion of a new section to provide a detailed explanation of the application of former §1022 in the particular context of the reg.

Final regulations that adopt the proposed regulations without modification other than certain nonsubstantive, clarifying changes.

In response to comments, IRS notes that nothing in the final regulations changes or invalidates the provisions of Revenue Procedure 2011-41, 2011-35 IRB 188, which provides a safe harbor that determines the effect on the application of various Code sections of a former §1022 election. The provisions relating to that safe harbor are available only if the executor of the estate makes a former §1022 election and takes no position contrary to a provision in Revenue Procedure 2011-41, and the safe harbor remains available to such qualifying taxpayers. Accordingly, IRS determined that it was unnecessary to incorporate Revenue Procedure 2011-41 into the final regulations. (T.D. 9811, 01/18/2017)

The final regulations are effective on January 19, 2017.

Preamble to Proposed Regulation 01/17/2017; Proposed Regulation §1.401(k)-1, Proposed Regulation §1.401(k)-6, Proposed Regulation §1.401(m)-1, Proposed Regulation §1.401(m)-5.

Under proposed reliance regulations, employer contributions to a 401(k) plan are treated as qualified matching contributions (QMACs) or qualified nonelective contributions (QNECs) if they satisfy applicable nonforfeitability and distribution requirements when they are allocated to participants' accounts. These contributions no longer have to meet the nonforfeitability and distribution requirements when they are contributed to the 401(k) plan.

To be considered a qualified cash or deferred arrangement (CODA), a plan must satisfy several requirements, including certain requirements relating to distributions, nonforfeiture, and nondiscrimination. Employer contributions taken into account for purposes of applying the nondiscrimination requirements may include, in addition to contributions made pursuant to an employee's election, matching contributions that meet the distribution and nonforfeitability requirements of §401(k)(2)(B) and §401(k)(2)(C), and QNECs. A QNEC is an employer contribution, other than a matching contribution, with respect to which the distribution and nonforfeitability requirements of §401(k)(2)(B) and §401(k)(2)(C) are met. (§401(m)(4)(C))

Special nondiscrimination rules require a 401(k) plan to satisfy one of two "actual deferral percentage (ADP) tests," so highly compensated employees cannot elect to defer a disproportionately higher amount of their salary. (§401(k)(3)(A)) Similar requirements-actual contribution percentage (ACP) tests-apply to limit employer matching or employee contributions made on behalf of highly compensated employees. (§401(m))

In applying the ADP and ACP tests, employers may, under conditions delineated in the regulations, take into account certain qualified matching contributions (QMACs) and qualified nonelective contributions (QNECs) made on behalf of the employer by the employer.

Under Regulation §1.401(k)-6, QMACs and QNECs are matching contributions and employer contributions (other than elective or matching contributions) that satisfy the nonforfeitability requirements of Regulation §1.401(k)-1(c) and the distribution requirements of Regulation §1.401(k)-1(d), "when they are contributed to the plan." Similarly, Regulation §1.401(m)-5, includes independent definitions of QMACs and QNECs, which are matching contributions and employer contributions (other than elective or matching contributions) that satisfy the nonforfeitability and distribution requirements of Regulation §1.401(k)-1(c) and Regulation §1.401(k)-1(d) "at the time the contribution is made."

Commenters have told IRS that employer contributions should be able to qualify as QMACs and QNECs as long as they satisfy applicable nonforfeitability and distribution requirements at the time they are allocated to participants' accounts, rather than when they are first contributed to the plan. These commenters contend that interpreting the statutory rules to require satisfaction of applicable nonforfeitability and distribution requirements at the time amounts are first contributed to the plan would preclude plan sponsors with plans that allow the use of amounts in plan forfeiture accounts to offset future employer contributions under the plan from applying such amounts to fund QMACs and QNECs. This is because the amounts would have been allocated to the forfeiture accounts only after a participant incurred a forfeiture of benefits and, thus, generally would have been subject to a vesting schedule when they were first contributed to the plan.

Commenters asked that QMAC and QNEC requirements not be interpreted to prevent the use of plan forfeitures to fund QMACs and QNECs. They urged that the nonforfeitability and distribution requirements under Regulation §1.401(k)-6 should apply when QMACs and QNECs are allocated to participants' accounts and not when the contributions are first made to the plan.

Under a proposed amendment to the regulations, amounts used to fund QMACs and QNECs must be nonforfeitable and subject to distribution restrictions in accordance with Regulation §1.401(k)-1(c) and Regulation §1.401(k)-1(d), when allocated to participants' accounts. (Proposed Regulation §1.401(k)-6)

IRS notes that, while the second sentence of each of the current definitions of QMACs and QNECs refers to the "vesting" requirements of Regulation §1.401(k)-1(c), those requirements are more appropriately characterized as "nonforfeitability" requirements consistent with section §401(k)(2)(C) and the title of Regulation §1.401(k)-1(c) ("nonforfeitability requirements"). Accordingly, the proposed regulations amend these definitions to clarify those references by replacing the word "vesting" with "nonforfeitability" in each definition; but IRS says these changes are not otherwise intended to have any substantive impact.

The proposed regulations also amend the definitions of QMACs and QNECs in Regulation §1.401(m)-5, to provide cross-references to the definitions of QMACs and QNECs under Regulation §1.401(k)-6. These amendments are being made to ensure a consistent definition of QMACs and QNECs in the regulations (including the requirement that amounts used to fund QMACs and QNECs be made subject to nonforfeitability and distribution requirements when they are allocated to participants' accounts as QMACs or QNECs) and are not otherwise intended to have any substantive impact. (Proposed Regulation §1.401(m)-5)

The changes to the regulations are proposed to apply to tax years beginning on or after the date that the regulations are finalized. (Proposed Regulation §1.401(k)-1(g)(5) and Proposed Regulation §1.401(m)-1(d)(4)) However, taxpayers may rely on the proposed regulations for periods preceding the proposed effective date. If, and to the extent, the final regulations are more restrictive than the rules in these proposed regulations, those provisions of the final regulations will be applied without retroactive effect. (Preamble to Proposed Regulation 01/18/2017)

Preamble to Proposed Regulation 12/28/2016, Proposed Regulation §1.430(h)(3)-1, Proposed Regulation §1.430(h)(3)-2, Proposed Regulation §1.431(c)(6)-1, Proposed Regulation §1.433(h)(3)-1.

Proposed regulations that would prescribe mortality tables to be used by most defined benefit pension plans. The tables would specify the probability of survival year-by-year for an individual based on age, gender, and other factors. This information would be used (together with other actuarial assumptions) to calculate the present value of a stream of expected future benefit payments for purposes of determining the minimum funding requirements for the plan. These mortality tables would also be relevant to determining the minimum required amount of a lump-sum distribution from such a plan. IRS has also proposed regulations that would update the requirements that a plan sponsor must meet in order to obtain IRS approval to use mortality tables specific to the plan for minimum funding purposes (instead of the generally applicable mortality tables).

§412 prescribes minimum funding requirements for defined benefit pension plans. §430, which was added to the Code by the Pension Protection Act of 1996 (P.L. 109-280), specifies the minimum funding requirements that apply generally to defined benefit plans that are not multi-employer plans.

§430(a) defines the minimum required contribution by reference to the plan's funding target for the plan year. Under §430(d)(1), a plan's funding target for a plan year generally is the present value of all benefits accrued or earned under the plan as of the first day of that plan year.

§430(h)(3) contains rules on the mortality tables to be used under §430. Under §430(h)(3)(A), except as provided in §430(h)(3)(C) (dealing with substitute mortality tables) or §430(h)(3)(D) (dealing with tables with respect to disabled individuals), IRS is to prescribe by regulations mortality tables to be used in determining any present value or making any computation under §430.

These mortality tables are to be based on the actual mortality experience of pension plan participants and projected trends in that experience. In prescribing these mortality tables, IRS is required to take into account results of available independent studies of mortality of individuals covered by pension plans. (§430(h)(3)(A)) Under §430(h)(3)(B), IRS is required to revise any mortality table in effect under §430(h)(3)(A) at least every 10 years to reflect actual mortality experience of pension plan participants and projected trends in that experience.

In July of 2008, IRS issued final regulations on the generally applicable mortality tables in Regulation §1.430(h)(3)-1 (the 2008 general mortality table regulations). The final regulations issued in 2008 also include rules on substitute mortality tables, which are set out in Regulation §1.430(h)(3)-2 (the 2008 substitute mortality table regulations).

The proposed regulations would set out the methodology IRS would use to update the generally applicable mortality tables that are used to determine present value or make any computation under §430. Pursuant to §417(e)(3)(B), a modified version of these updated tables would be used for purposes of determining the amount of a single-sum distribution (or another accelerated form of distribution). This methodology for developing updated tables under §430(h)(3)(A) is being proposed pursuant to the requirement under §430(h)(3)(B) to revise the mortality tables used under §430 to reflect the actual mortality experience of pension plan participants and projected trends in that experience. As under the 2008 general mortality table regulations, the methodology involves the separate determination of base tables and the projection of mortality improvement.

The proposed regulations would also set out rules for the use of substitute mortality tables. The rules on substitute mortality tables are being proposed pursuant to section 503 of the Bipartisan Budget Act of 2015, which requires that the determination of whether a plan has credible mortality information (necessary to create a substitute mortality table) be made in accordance with established actuarial credibility theory. Pursuant to that requirement, IRS undertook a review of actuarial literature regarding credibility theory and consulted with experts on that topic from the Society of Actuaries. Based on that review and analysis, the proposed regulations would set out a method for developing substitute mortality tables that is materially different from the method that is required under the 2008 substitute mortality table regulations and the associated revenue procedure, Revenue Procedure 2008-62, 2008-2 CB 935.

The method for developing substitute mortality tables that is set out in the proposed regulations would be simpler than the method that applies under the 2008 substitute mortality table regulations and would also accommodate the use of substitute mortality tables by plans with smaller populations that have partially credible mortality experience. IRS requests comments on additional simplifications that might be appropriate for use in developing substitute mortality tables.

The regulations are proposed to apply to plan years beginning on or after January 1, 2018. Under the proposed regulations, a plan sponsor may use a substitute mortality table for a plan year beginning on or after January 1, 2018 only if that substitute mortality table is approved as provided in the proposed regulations.

T.D. 9797, 12/01/2016; Regulation §1.6035-2.

Final regulations that provide that the earliest due date for providing statements to IRS and to beneficiaries, under the rules requiring consistent basis reporting for estate tax and income tax purposes, was June 30, 2016. The regulations thus confirm the rule contained in Notice 2016-27, 2016-15 IRB 576.

The executor or administrator of a decedent's estate must file the estate tax return. (§6018(a))

If the executor or administrator is unable to make a complete return with respect to any part of the gross estate, he must include in his return all the information he has, including a description of such part and the name and address of every person holding a legal or beneficial interest in such part. If they are notified by IRS, such legal or beneficial owners must then file returns as to their parts of the estate. (§6018(b))

On July 31, 2015, President Obama signed into law the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (P.L. 114-41; the Act). Section 2004 of the Act enacted §1014(f) and §6035.

Under the Act, effective for property with respect to which an estate tax return is filed after July 31, 2015, the basis of any property to which §1014(a) (i.e., the rules for determining basis of property acquired from a decedent) applies cannot exceed:

a. In the case of property, the final value of which has been determined for purposes of the estate tax on the estate of the decedent, such value.

b. In the case of property not described in (A), above, and with respect to which a statement has been furnished under new §6035(a) identifying the value of such property, such value. (§1014(f)(1))

§6035 imposes reporting requirements with regard to the value of property included in a decedent's gross estate for federal estate tax purposes.

§6035(a)(1) provides that the executor of any estate required to file an estate tax return under §6018(a) must furnish, both to IRS and the person acquiring any interest in property included in the decedent's gross estate for federal estate tax purposes, a statement identifying the value of each interest in such property as reported on such return and such other information with respect to that interest as IRS may prescribe.

Under §6035(a)(2), each person required to file a return under §6018(b) must furnish, both to IRS and each other person who holds a legal or beneficial interest in the property to which such return relates, a statement identifying the information described in §6035(a)(1).

§6035(a)(3)(A) provides that each statement required to be furnished under §6035(a)(1) or §6035(a)(2) must be furnished at such time as IRS may prescribe, but in no case at a time later than the earlier of: (i) the date which is 30 days after the date on which the return under §6018 was required to be filed (including extensions, if any); or (ii) the date which is 30 days after the date such return is filed.

Notice 2015-57, 2015-36 IRB 294, provided that, for statements required under §6035(a)(1) and §6035(a)(2) to be filed with IRS or furnished to a beneficiary before February 29, 2016, the due date under §6035(a)(3) was delayed to February 29, 2016. Notice 2016-19, 2016-9 IRB 362, provided the same rule, except with March 31, 2016 substituted for February 29, 2016. Then, in temporary regulations issued in early March, 2016, IRS reiterated the March 31, 2016 date by saying that executors and other persons required to file or furnish a statement under §6035(a)(1) or §6035(a)(2) before March 31, 2016, need not do so until March 31, 2016. (Regulation §1.6035-2T(a)) And, then, in late March, 2016, IRS announced that statements required under §6035(a)(1) and §6035(a)(2) to be filed with IRS or furnished to a beneficiary before June 30, 2016 need not be filed with IRS and furnished to a beneficiary until June 30, 2016.

IRS has now withdrawn the portion of the March temporary regulations that contained the March 31, 2016 initial due date (T.D. 9797, 12/01/2016) and issued final regulations with the June 30, 2016 that was contained in Notice 2016-27. (Regulation §1.6035-2)

Revenue Procedure 2017-43, 2017-32 IRB.

Revenue Procedure that, effective for applications submitted on or after September 1, 2017, revises the procedures for applying for the Treasury Department's approval of a suspension of benefits under a multi-employer defined benefit pension plan that is in critical and declining status under §432(e)(9).

The Multiemployer Pension Reform Act of 2014 (MPRA)-Division O of the Consolidated and Further Continuing Appropriations Act (P.L. 113-235)-amended §432(e)(9) and ERISA §305(e)(9) to allow the sponsor of a multiemployer defined benefit plan in critical and declining status to submit to the Secretary of the Treasury (Secretary) a proposal to suspend benefits in certain situations. MPRA requires the Secretary to approve a plan sponsor's proposed suspension if the plan is eligible for the proposed suspension and the proposed suspension satisfies §432(e)(9)(C) through §432(e)(9)(F).

A plan sponsor of a plan in critical and declining status may suspend benefits only if the actuarial certification requirement in §432(e)(9)(C)(i), and the plan sponsor determinations requirement in §432(e)(9)(C)(ii) are satisfied. Any suspension of benefits made by a plan sponsor is subject to certain limitations under §432(e)(9)(D).

On April 28, 2016, IRS published final regulations (TD 9765) under §432(e)(9) and, contemporaneously with the final regulations, issued Revenue Procedure 2016-27, 2016-19 IRB 725.

Revenue Procedure 2016-27 prescribed the specifics on how to apply for approval of a proposed benefit suspension. Applications for such approval have been accepted by the Treasury Department on and after April 26, 2016. Revenue Procedure 2016-27 also provided a model notice (Appendix A) that a plan sponsor proposing a benefit suspension could use to satisfy the statutory notice requirement.

Revenue Procedure 2017-43 contains revised procedures for applications for a suspension of benefits under a multi-employer defined benefit pension plan that is in critical and declining status under §432(e)(9). These procedures replace the procedures set out in Revenue Procedure 2016-27 and are intended to facilitate the review of an application for a suspension of benefits in light of the experience of the Treasury Department in processing applications. The procedures set out in Revenue Procedure 2017-43 must be followed for applications submitted on or after September 1, 2017.

Revenue Procedure 2017-43 supersedes Revenue Procedure 2016-27 for submissions made on or after September 1, 2017. Revenue Procedure 2017-43 includes the following changes from Revenue Procedure 2016-27:

a. Provides that if IRS identifies an error in the application after it is submitted, then IRS may request that the plan sponsor provide additional materials to correct the error;

b. Contains a new requirement that the projected withdrawal liability payments that are included as part of the projection of the plan's available resources, and as part of the support for the certification that the plan is projected to avoid insolvency, must be separately identified as projected payments attributable to prior withdrawals, and projected payments attributable to expected future withdrawals;

c. Replaces the requirement to provide sample calculations for the guarantee-based limit, and the disability-based limit, for an individual in each category or group that is treated differently under the suspension, with a requirement that those sample calculations be provided only for an individual currently receiving benefits, a contingent beneficiary of an individual currently receiving benefits, and a future retiree;

d. Clarifies the age categories for which sample calculations for the age-based limit must be provided;

e. Provides that certain information that would otherwise be required to demonstrate that the proposed suspension is equitably distributed need not be provided for an application in connection with a proposed partition of a plan under ERISA §4233;

f. Clarifies the different categories of individuals for which sample notices must be provided as part of the application;

g. Adds a new appendix to consolidate the descriptions of the actuarial assumptions used for certain illustrations and projections included in the application, and to provide additional detail regarding those assumptions;

h. Requires the inclusion of a narrative statement of the reasons that the plan is in critical and declining status;

i. Adds a requirement to provide (as part of the required excerpts from the most recently filed Form 5500) the accountant's report under ERISA §103(a)(3); and

j. Adds a requirement to provide the date on which IRS indicated that the application is a candidate for resubmission review, if applicable.

Revenue Procedure 2017-37, 2017-21 IRB.

Annual inflation-adjusted contribution, deductible, and out-of-pocket expense limits for 2018 for health savings accounts (HSAs).

Eligible individuals may, subject to statutory limits, make deductible contributions to an HSA. Employers as well as other persons (e.g., family members) also may contribute on behalf of an eligible individual. Employer contributions generally are treated as employer-provided coverage for medical expenses under an accident or health plan and are excludable from income. In general, a person is an "eligible individual" if he is covered under a high deductible health plan (HDHP) and is not covered under any other health plan that is not a high deductible plan, unless the other coverage is permitted insurance (e.g., for worker's compensation, a specified disease or illness, or providing a fixed payment for hospitalization). General purpose health accounts (flexible spending accounts (FSAs)) and health reimbursement arrangements (HRAs) constitute "other coverage" that will generally preclude HSA eligibility. However, exceptions apply for, among other things, limited purpose FSAs and HRAs (those providing only certain benefits, e.g., dental and vision) and FSAs and HRAs imposing high annual deductibles.

HSA distributions not used to pay for qualifying medical expenses generally are included in income and subject to a 10% penalty tax.

For calendar year 2018, the limitation on deductions under §223(b)(2)(A) for an individual with self-only coverage under an HDHP is $3,450 (up from $3,400 for 2017). For calendar year 2018, the limitation on deductions under §223(b)(2)(B) for an individual with family coverage under an HDHP is $6,900 (up from $6,750 for 2017).

For calendar year 2018, an HDHP is defined under §223(c)(2)(A) as a health plan with an annual deductible that is not less than $1,350 (up from $1,300 for 2017) for self-only coverage or $2,700 (up from $2,600 for 2017) for family coverage, and with respect to which the annual out-of-pocket expenses (deductibles, co-payments, and other amounts, but not premiums) do not exceed $6,650 (up from $6,550 for 2017) for self-only coverage or $13,300 (up from $13,100 for 2017) for family coverage.

Revenue Procedure 2017-34, 2017-26 IRB.

Permanently available simplified method for estates to obtain an extension of time to make the estate tax portability election. The simplified method is only available to estates that are not required to file an estate tax return based on the value of the gross estate, and it is effective June 9, 2017.

§2010(c) allows the estate of a decedent who is survived by a spouse to make a portability election, which allows the surviving spouse to apply the decedent's unused exclusion amount to the surviving spouse's own transfers during life and at death. The amount received by the surviving spouse is called the deceased spousal unused exclusion, or DSUE, amount.

§2010(c)(5)(A) provides certain requirements that the executor of the estate of a deceased spouse must satisfy to allow the decedent's surviving spouse to apply the decedent's DSUE amount to the surviving spouse's transfers. In particular, the executor of the estate of the deceased spouse must elect portability of the DSUE amount on a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, which must include a computation of the DSUE amount. Under §2010(c)(5)(A), a portability election is effective only if made on a Form 706 that is filed within the time prescribed by law (including extensions) for filing such return.

Regulation §20.2010-2(a)(1) provides that an estate that elects portability will be considered to be required to file a return under §6018(a). Accordingly, the due date of an estate tax return required to elect portability is nine months after the decedent's date of death or the last day of the period covered by an extension (if an extension of time for filing has been obtained). An extension is available to an estate that is not required to file an estate tax return under §6018(a), as determined based on the value of the gross estate and adjusted taxable gifts and without regard to the need to file for portability election purposes. (Regulation §20.2010-2(a)(1))

Regulation §20.2010-2(a)(2) provides that, upon the timely filing of a complete and properly-prepared estate tax return, an executor of an estate of a decedent survived by a spouse will have elected portability of the decedent's DSUE amount unless the executor chooses not to elect portability and satisfies the requirements in Regulation §20.2010-2(a)(3)(i) for the election not to apply.

Where an estate is filing an estate tax return only to make a portability election, Regulation §301.9100-3 provides the rules for granting an extension of time to elect portability. In general, under Regulation §301.9100-3, relief will be granted if the taxpayer establishes to IRS's satisfaction that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government.

Revenue Procedure 2014-18, 2014-7 IRB 513 provided a simplified method for obtaining an extension of time under Regulation §301.9100-3 to make a portability election, that was available if the estate was not required by §6018(a) to file an estate tax return and if such a decedent was survived by a spouse. However, this simplified method was available only on or before December 31, 2014.

Generally, under §6511(a), a taxpayer's claim for credit or refund of an overpayment of tax must be filed within three years from the date of filing the tax return, or within two years from the date of payment of the tax, whichever period expires later.

IRS has provided a permanently available simplified method for estates to obtain an extension of time to make the estate tax portability election. The simplified method is only available to estates that are not required to file an estate tax return based on the value of the gross estate, and it is effective June 9, 2017.

IRS explained that, since December 31, 2014, it has issued numerous letter rulings under Regulation §301.9100-3 granting an extension of time to elect portability under §2010(c)(5)(A) in situations in which the decedent's estate was not required by §6018(a) to file an estate tax return. IRS determined that the considerable number of ruling requests for an extension of time to elect portability received since December 31, 2014 indicates a need for continuing relief for the estates of decedents having no filing requirement under §6018(a). Further, the considerable number of ruling requests received has placed a significant burden on IRS.

A taxpayer who meets the requirements listed below will be deemed to meet the requirements for relief under Regulation §301.9100-3, and relief is granted under the provisions of Regulation §301.9100-3 to extend the time to elect portability under §2010(c)(5)(A). Accordingly, for purposes of electing portability, the taxpayer's Form 706 will be considered to have been timely filed in accordance with Regulation §20.2010-2(a)(1). (Revenue Procedure 2017-34, §4.02)

In order to qualify for the automatic extension, the following requirements must be met:

1. The taxpayer is the executor of the estate of a decedent who: (a) has a surviving spouse; (b) died after December 31, 2010; and (c) was a citizen or resident of the U.S. on the date of death;

2. The taxpayer is not required to file an estate tax return under §6018(a) (as determined based on the value of the gross estate and adjusted taxable gifts, without regard to the need to file for portability purposes);

3. The taxpayer did not file an estate tax return within the time prescribed by Regulation §20.2010-2(a)(1) for filing an estate tax return required to elect portability;

4. The executor must file a complete and properly-prepared Form 706 on or before the later of January 2, 2018, or the second annual anniversary of the decedent's date of death; and

5. The executor filing the Form 706 on behalf of the decedent's estate must state at the top of the Form 706 that the return is "FILED PURSUANT TO REVENUE PROCEDURE 2017-34 TO ELECT PORTABILITY UNDER §2010(c)(5)(A)." (§3.01; §4.01)

IRS notes that making the simplified method of Revenue Procedure 2017-34 available for all eligible estates through January 2, 2018 provides additional relief to the estates of decedents with a date of death in the first years after the enactment of the portability election provisions because the executors of those estates and their advisors may not have been aware of the opportunity and need to file an estate tax return to elect portability. Making the simplified method of this revenue procedure available after January 2, 2018, to estates during the 2-year period immediately following the decedent's date of death should not unduly compromise the ability of the taxpayer or IRS to compute and verify the DSUE amount because the necessary records are likely to be available during that period.

The new procedures do not apply to taxpayers that filed an estate tax return within the time prescribed by Regulation §20.2010-2(a)(1) for the purpose of electing portability. Such a taxpayer either will have elected portability of the DSUE amount by timely filing that estate tax return or will have affirmatively opted out of portability in accordance with Regulation §20.2010-2(a)(3)(i). (§3.02)

Taxpayers that are not eligible for relief under this revenue procedure because the executor does not satisfy requirements (4) and/or (5) above may request an extension of time to make the portability election under §2010(c)(5)(A) by requesting a letter ruling under the provisions of Regulation §301.9100-3. (§3.03)

If, subsequent to the grant of relief pursuant to this revenue procedure, it is determined that, based on the value of the gross estate and taking into account any taxable gifts, the taxpayer was required to file an estate tax return pursuant to §6018(a), the grant of an extension under this revenue procedure becomes void. (§4.03)

If the increase in the surviving spouse's applicable exclusion amount attributable to the addition of the decedent's DSUE amount as of the decedent's date of death results in an overpayment of gift or estate tax by the surviving spouse or his or her estate, no claim for credit or refund may be made if the period of limitations under §6511(a) for filing a claim for credit or refund of an overpayment of tax with respect to such transfer has expired. That is, an extension of time to elect portability granted under this revenue procedure does not extend the period during which the surviving spouse or the surviving spouse's estate may make a claim for credit or refund under §6511(a). (§5.01)

Because a surviving spouse has no DSUE amount from a deceased spouse to apply to such surviving spouse's transfers until the portability election has been made by the deceased spouse's executor (see Regulation §20.2010-3(a)(2) and Regulation §25.2505-2(a)(2)), a claim for credit or refund of tax filed within the time prescribed in §6511(a) by the surviving spouse or the estate of the surviving spouse, in anticipation of a Form 706 being filed to elect portability pursuant to this revenue procedure, will be considered a protective claim for credit or refund of tax. (§5.02)

Example: Predeceasing Spouse (S1) dies on January 1, 2014, survived by Surviving Spouse (S2). The assets includible in S1's gross estate consist of cash held jointly with S2 with rights of survivorship, in the amount of $2,000,000. S1 made no taxable gifts during life. S1's executor is not required to file an estate tax return under §6018(a) and does not file such a return.

Example: S2 dies on January 30, 2014. S2's taxable estate is $8,000,000, and S2 made no taxable gifts during life. S2's executor files a Form 706 on behalf of S2's estate on October 30, 2014, claiming an applicable exclusion amount of $5,340,000. S2's executor includes payment of the estate tax with the Form 706. Pursuant to this revenue procedure, S1's executor files a complete and properly prepared Form 706 on behalf of S1's estate on December 1, 2017, reporting a DSUE amount of $5,340,000. The executor includes at the top of the Form 706 the required statement. The filing of the return satisfies the requirements for a grant of relief under this revenue procedure, and S1's estate is deemed to have made a valid portability election. IRS accepts S1's return with no changes. To recover the estate tax paid, S2's executor must file a claim for credit or refund of tax by October 30, 2017 (the end of the period of limitations prescribed in §6511(a)), even though a Form 706 to elect portability has not been filed on behalf of S1's estate by that date. Such a claim filed on Form 843, Claim for Refund and Request for Abatement, in anticipation of the filing of the Form 706 by S1's executor, will be considered a protective claim for credit or refund of tax. Accordingly, as long as the Form 843 is filed on or before October 30, 2017, IRS can consider and process that claim for credit or refund of tax once S1's estate is deemed to have made a valid portability election and S2's estate notifies IRS that the claim for credit or refund is ready for consideration. (§5.03(1))

Through the later of January 2, 2018 or the second anniversary of a decedent's date of death, the exclusive procedure for obtaining an extension of time under Regulation §301.9100-3 to make a portability election under §2010(c)(5)(A) for the estate of a decedent, if the decedent and executor meet the requirements (1)-(3) above, is the procedure described in requirements (4) and (5) above. (§7.02)

If an executor of such an estate has filed a request for a letter ruling seeking an extension of time under Regulation §301.9100-3 to make a portability election under §2010(c)(5)(A), and that letter ruling is pending in the IRS National Office on June 9, 2017, IRS will close its file on the ruling request and refund the user fee, and the estate may obtain the relief granted by this revenue procedure only by complying with requirements (4) and (5) above. (§7.02)

No user fee applies to Revenue Procedure 2017-34. (§1)

Observation: Revenue Procedure 2017-34 shares many of the same provisions contained in Revenue Procedure 2014-18.

CCA 201736022

Guidance, in the form of two representative factual scenarios, of how a cure period described in Regulation §1.72(p)-1, Q&A-10(a), applies for a participant who failed to make installment payments required under the terms of a plan loan. Under both scenarios-one of which was remedied by subsequent payments applied to those that were missed and the other of which involved a refinancing-the missed payments were cured within the applicable period and did not result in a deemed distribution of the loan.

Under §72(p)(1), if a participant receives (directly or indirectly) a loan from a qualified employer plan (generally, a §401(a) qualified plan, §403(a) annuity plan, or §403(b) plan), the amount of the loan will be treated as having been received by the participant as a distribution from the plan.

However, under §72(p)(2), a loan will not be treated as a distribution if it meets certain requirements, including that it not exceed certain limitations, that it be repaid within five years (except when it is a home loan), and that it require substantially level amortization of the loan (with payments not less frequently than quarterly) over the term of the loan. In addition, the loan must be evidenced by a legally enforceable agreement. (Regulation §1.72(p)-1, Q&A-3(a))

A deemed distribution occurs for §72 purposes at the first time that the requirements of Regulation §1.72(p)-1, Q&A-3 are not met, either in form or in operation. (Regulation §1.72(p)-1, Q&A-4) And, if a loan initially satisfies those requirements, but payments are not made in accordance with the terms of the loan, a deemed distribution occurs as a result of such failure. (Regulation §1.72(p)-1, Q&A-10) A failure to make any installment payment when due violates the level amortization requirement in §72(p)(2)(C) and results in a deemed distribution at the time of such failure. (Regulation §1.72(p)-1, Q&A-10(a)) However, a plan administrator may allow a cure period, lasting not later than the last day of the calendar quarter following the calendar quarter in which the required installment payment was due. Under Regulation §1.72(p)-1, Q&A-10(b), if a loan, when made, satisfies the requirements of Regulation §1.72(p)-1, Q&A-3, but there is a failure to pay an installment payment required under the loan (taking into account any cure period permitted in Regulation §1.72(p)-1, Q&A-10(a)), then the amount of the deemed distribution is equal to the entire outstanding balance of the loan (including any accrued interest) at the time of such failure. A participant may, however, refinance a loan if the loans collectively satisfy the amount limitations of §72(p)(2)(A) and the replaced loan and the replacement loan each satisfy the requirements of §72(p)(2)(B), §72(p)(2)(C), and Regulation §1.72(p)-1.

Taxpayer is a participant in a 401(k) plan that permits plan loans and, on January 1, 2018, receives a loan from the plan in an amount that does not exceed the limit under §72(p)(2)(A). The loan is not a home loan, it is evidenced by a legally enforceable agreement as required under Regulation §1.72(p)-1, Q&A-3(b), and it is repayable in five years. Level installment payments are due at the end of each month of the loan's term, with the first due January 31, 2018, and the last due December 31, 2022.

The plan also allows for a cure period under Regulation §1.72(p)-1, Q&A-10(a), under which a participant (like Taxpayer) can make up a missed installment payment by the last day of a calendar quarter following the calendar quarter in which the payment was due.

Situation 1. Taxpayer makes timely installment payments from January 31, 2018, through February 28, 2019, but then misses the next two payments (due March 31 and April 30, 2019). Taxpayer makes installment payments on May 31, 2019 (which is applied to the missed March 31, 2019 installment payment) and June 30, 2019 (which is applied to the missed April 30, 2019 installment payment). On July 31, 2019, Taxpayer makes a payment equal to three installment payments (which is applied to the missed May 31, and June 30, 2019 installment payments, as well as the required July 31, 2019 installment payment).

Situation 2. Taxpayer makes timely installment payments from January 31, 2018, through September 30, 2019, but then misses the next three payments (due October 31, Nov. 30, and December 31, 2019). On January 15, 2020, Taxpayer refinances the original loan and replaces it with a new "replacement" loan equal to the outstanding balance of the original loan, including the three missed payments. By its terms, the replacement loan (which is assumed to satisfy the requirements of §72(p)(2)(A) through (C), as well as Regulation §1.72(p)-1, Q&A-3 and -20) is to be repaid in level monthly installments at end of each month through the end of the original loan's repayment term (i.e., December 31, 2022).

The CCA held that, in both situations, Taxpayer's missed installment payments do not violate the level amortization requirement under §72(p)(2)(C) because the missed payments are cured within the applicable cure period. Accordingly, there is no deemed distribution of the loan due to the missed installment payments.

IRS reasoned that in Situation 1, the two missed installment payments (due March 31, and April 30, 2019) have separate cure periods-June 30, and September 30, 2019, respectively-because they occur in separate calendar quarters. And, both of these missed installment payments are cured within their respective cure periods. Specifically, the missed March 31, 2019 payment is cured by the payment made on May 31, 2019, and the missed April 30, 2019 payment is cured by the payment made on June 30, 2019. However, applying these later payments to the missed payments resulted in the May 31, and June 30, 2019 installment payments being missed by virtue of those payments' application to the earlier missed installment payments. The missed May 31, 2019 installment payment and the missed June 30, 2019 installment payment have a cure period that ends September 30, 2019, and both of these missed payments are cured by the payment made on July 31, 2019. Accordingly, the level amortization requirement under §72(p)(2)(C) is not violated and there is no deemed distribution from the missed payments.

With respect to Situation 2, the three missed installment payments (due October 31, Nov. 30, and December 31, 2019) occur in the same calendar quarter and thus have the same cure period, which ends March 31, 2020. The replacement loan created by the refinancing of the original loan on January 15, 2020, pays off the entire outstanding balance of the original loan, including the three missed payments, within the missed installment payments' cure period (i.e., before March 31, 2020). Accordingly, under Regulation §1.72(p)-1, Q&A-10, the level amortization requirement under §72(p)(2)(C) is not violated for the replaced loan and there is no deemed distribution from the three missed installment payments.

CCA 201725027.

Consequences under the §409A(a)(1)(A) nonqualified deferred compensation rules of certain distributions made under a taxpayer's back-to-back arrangement.

All amounts deferred under a nonqualified deferred compensation plan for all tax years are currently includible in income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless the plan: (a) meets the distribution, acceleration of benefit, and election requirements under §409A; and (b) is operated in accordance with them. (§409A(a)(1)(A)) Noncompliance results in inclusion in income for all amounts deferred under the plan by a participant, an interest charge (at the underpayment rate plus one percentage point), and an additional 20% tax. (§409A(a)(1)(B))

The requirements under §409A include that compensation deferred under a plan may be paid only upon the occurrence of the following events:

a. The service provider's separation from service;
b. The service provider becoming disabled;
c. The service provider's death;
d. A time or fixed schedule set out in the plan;
e. A change in ownership or control of a corporation; and
f. The occurrence of an unforeseeable emergency. (§409A(a)(2), Regulation §1.409A-3(a))

In general, Regulation §1.409A-3(a) does not allow a payment to a service provider merely because of the separation from service of another service provider. However, Regulation §1.409A-3(i)(6)(i) provides an exception for a back-to-back arrangement that meets certain requirements. Regulation §1.409A-3(i)(6)(i) applies to an arrangement where (1) a service provider is providing services to a service recipient (the intermediate service recipient), who in turn is providing services to another service recipient (the ultimate service recipient), and the services provided by the service provider to the intermediate service recipient are closely related to the services provided by the intermediate service recipient to the ultimate service recipient; and (2) there is a nonqualified deferred compensation plan providing for payments by the ultimate service recipient to the intermediate service recipient (the ultimate service recipient plan), there is a nonqualified deferred compensation plan or other agreement, method, program, or other arrangement providing for payments of compensation by the intermediate service recipient to the service provider (the intermediate service recipient plan), and the intermediate service recipient plan provides for a payment upon the occurrence of a permitted event.

In the case of back-to-back arrangements, despite the limitations on distributions described above, the ultimate service recipient plan may provide for a payment to the intermediate service recipient on the occurrence of a separation from service, disability, death, a change in control, or an unforeseeable emergency under the intermediate service recipient plan if: (a) the time and form of payment is defined as the same time and form of payment provided under the intermediate service recipient plan; (b) the amount of the payment under the ultimate service recipient plan does not exceed the amount of the payment under the intermediate service recipient plan, and (c) the ultimate service recipient plan and the intermediate service recipient plan otherwise satisfy the §409A requirements. (Regulation §1.409A-3(i)(6)(i))

Under §409A(a)(2), deferred compensation amounts must be paid on the dates set out in the plan, and accelerated payments and delayed payments are generally not permissible. (Regulation §1.409A-3(j)(1))

Regulation §1.409A-2(b)(1) provides a plan may not delay a payment unless an election is made to delay the payment at least 12 months before the payment is scheduled to be made and the payment is delayed at least five years beyond the date the payment was originally scheduled to be made.

Under Regulation §1.409A-3(d), if a plan sets out fixed payment dates, an actual payment may be made 30 days before or the specified date or until the end of the service provider's tax year in which the specified date or event occurs. If the service provider's tax year ends less than 2-½ months following the specified payment date, the payment can be made by the 15th day of the third month after the specified date.

U.S. taxpayer (Taxpayer) managed many investment funds, both overseas and in the U.S., including Foreign Corporation (Foreign Corp). Foreign Corp paid Taxpayer management and performance fees for investment advisory services, and Taxpayer in turn employed individual investment professionals who received salaries and bonuses for management and investment advisory services performed.

Foreign Corp and Taxpayer were parties to a deferred compensation arrangement (USR Plan) under which Taxpayer deferred some of its management fees and/or performance fees. Taxpayer in turn sponsored a deferred compensation arrangement (ISR Plan) for individual investment professionals (Participants) working for Taxpayer.

The USR Plan and the ISR Plan were intended to be "back-to-back" arrangements. Thus, under the USR Plan and the ISR Plan, Taxpayer's deferral elections were coordinated with the Participant's deferral elections, and the payment events triggering payments from Foreign Corp to Taxpayer under the USR Plan were coordinated with the payment events triggering payments to the Participants under the ISR Plan. Thus, for example if a Participant was entitled to a payment of deferred compensation upon separation from service under the ISR Plan, then Taxpayer was likewise entitled to a payment in the same amount under the USR Plan.

The USR Plan provided that a payment of deferred compensation was to be made to Taxpayer when an amount was forfeited by a Participant. Thus, under the terms of the USR Plan between Taxpayer and Foreign Corp, an amount was to be paid to Taxpayer even though the amount was forfeited by a Participant (and thus not paid to the Participant) because the Participant separated from service before the vesting date.

In addition, Taxpayer elected to be paid deferred compensation on certain dates and in certain amounts over several tax years. In some tax years, the payments actually made were less than the amounts called for under the USR Plan, and, in other tax years, the payments actually made were more than the amounts called for under the USR Plan.

Taxpayer also accelerated the vesting of the amount owed to Employee A (who separated from service) under the ISR Plan. While Taxpayer paid the amount to Employee A pursuant to the terms of the ISR Plan, Foreign Corp did not pay an amount equal to the amount paid to A to Taxpayer as required under the USR Plan, and Taxpayer did not include this amount in income.

In the CCA, IRS concluded that the USR Plan failed to meet the requirements of §409A.

The USR Plan provided that unvested amounts forfeited by Participants were nevertheless to be paid to Taxpayer. Thus, under the terms of the USR Plan, an amount paid to Taxpayer upon the separation from service of a Participant could be in excess of the amount paid to the Participant. Accordingly, the requirements under Regulation §1.409A-3(i)(6) were not met because the amount of the payment under the ultimate service recipient plan might exceed the amount of the payment under the intermediate service recipient plan. Consequently, the requirement for the exception for back-to-back arrangements was not met, and so the USR Plan included a payment provision that failed to meet the requirements of Regulation §1.409A-3(a).

Regulation §1.409A-3(i)(6) provides that the amount of the payment under the ultimate service recipient plan may not exceed the amount of the payment under the intermediate service recipient plan. Therefore, the USR Plan failed to meet the requirements of §409A because the USR Plan provision providing for a payment to Taxpayer in the event of a Participant's separation from service before vesting was an impermissible payment event.

As a result, all vested amounts deferred under the USR Plan for the first open year that had not been previously included in income were includable in gross income under §409A(a)(1)(A) and were subject to the additional taxes under §409A(a)(1)(B). For tax years after the earliest open year, Taxpayer had to include under §409A(a)(1)(A) the vested amount deferred under the USR Plan, less amounts included for previous tax years.

And, with regard to the plan making payments in amounts more or less than those specified in the plan, IRS concluded that Taxpayer failed to meet the requirements of §409A(a)(A) because the payments made under the USR Plan were not made at the time and in the amount specified in the plan. Accordingly, all compensation deferred under the plan for the tax year and all preceding tax years was includible in gross income for the tax year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

Further, because the USR Plan did not pay Taxpayer an amount equal to the amount paid to Employee A as required under the terms of the USR Plan, IRS found that the USR Plan was not operated in accordance with the requirements of §409A(a)(2). While Regulation §1.409A-3(a) provides that a payment from a plan may be made only upon the occurrence of certain events-one if which is a separation of service of a participant- Regulation §1.409A-3(i)(6) provides that payments under an ultimate service recipient plan to the intermediate service provider must match the payments made under the intermediate service recipient plan to the ultimate service provider. Here, the terms of the USR Plan were not followed, and Foreign Corp did not pay an amount equal to the amount paid to Employee A. Accordingly, all compensation deferred under the plan for the tax year and all preceding tax years was includible in gross income for the tax year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

Chief Counsel Advice 201703013.

Payments received by an employee from an employer under an employer-provided fixed indemnity health plan are not excludible under §105 if the value of the coverage was excluded from the employee's gross income and wages. The CCA reached similar conclusions with respect to payments from certain plans that the employees contributed to via salary reductions through a §125 cafeteria plan.

Employer-paid premiums for accident or health insurance coverage are excluded under §106(a). Under §105(b), an employee excludes amounts received through employer-provided accident or health insurance if they are paid to reimburse expenses incurred by the employee for medical care (of the employee, the employee's spouse, or the employee's dependents, as well as children of the employee who are not dependents but have not attained age 27 by the end of the taxable year) for personal injuries or sickness. To the extent amounts received through employer-provided accident or health insurance are paid without regard to the amount of expenses incurred by the employee for medical care, the amounts are not excluded from gross income because the amounts are not paid to reimburse expenses incurred by the employee for personal injuries and sickness.

Amounts received through accident or health insurance for personal injuries or sickness are generally excluded from gross income under §104(a)(3). This exclusion does not apply, however, if the amounts are either (1) attributable to contributions by the employer that were not includible in the gross income of the employee or (2) paid by the employer. (Regulation §1.104-1(d)) For this purpose, salary reduction under a §125 cafeteria plan (below) is treated as an employer contribution, and not an employee contribution.

Under the §125 cafeteria plan rules, an employee's salary reduction applied to buy health insurance coverage is not included in gross income, and the coverage is excluded under §106 as employer-provided accident or health coverage.

The CCA presents five different examples of fixed indemnity health plans and wellness plans, each of which qualifies as an accident or health plan under §106, that are provided to employees regardless of whether they enroll in other comprehensive health coverage. A fixed indemnity health plan is a plan that pays covered individuals a specified amount of cash for the occurrence of certain health-related events, such as office visits or days in the hospital. The amount paid is not related to the amount of any medical expense incurred or coordinated with other health coverage.

Situation 1: An employer allows all employees to enroll in coverage under a fixed indemnity health plan. Employees pay premiums for the plan by deducting the amount of the premium each pay period from the employee's salary; the amount of the deducted premium is included in gross income and wages for federal tax purposes.

Situation 2: The same facts as Situation 1, except the employer provides the coverage to the employees at no cost to the employee.

Situation 3: The same facts as Situation 1, except the employees electing to participate in the plan pay premiums by salary reduction through a §125 cafeteria plan (and therefore the amount of the salary reduction is not included in compensation income at the time the salary would otherwise have been paid).

Situation 4: An employer allows all employees to enroll in coverage under a "wellness plan." Employees electing to participate in the plan pay an employee contribution by salary reduction through a §125 cafeteria plan. The plan pays employees fixed indemnity cash payment benefits for completing a health risk assessment, for participating in certain prescribed health screenings, and for participating in other prescribed preventive care activities.

Situation 5: An employer allows all employees to enroll in coverage under a wellness plan. Employees electing to participate in the plan make an employee contribution by salary reduction through a §125 cafeteria plan. The plan pays employees a fixed indemnity cash payment benefit each pay period for participating in the wellness plan.

IRS's Office of Chief Counsel was asked: (i) whether payments received by an employee from an employer under a fixed indemnity health plan are excludible from the employee's income under §105; and (ii) whether payments received by an employee from an employer under a fixed indemnity health plan are excludible from the employee's income under §105 if the amounts paid by the employee for coverage under the plan were made by salary reduction through a §125 cafeteria plan (and therefore not included in the employee's compensation income at the time the amounts were paid).

The CCA concluded that: (i) an employer may not exclude from an employee's gross income payments under an employer-provided fixed indemnity health plan if the value of the coverage was excluded from the employee's gross income and wages; and (ii) an employer may not exclude from an employee's gross income payments under an employer-provided fixed indemnity health plan if the premiums for the fixed indemnity health plan were originally made by salary reduction through a §125 cafeteria plan.

The CCA reasoned that the value of coverage by an employer-provided wellness program that provides "medical care" (as defined under §213(d)) generally is excluded from an employee's gross income under §106(a), and any reimbursements or payments for medical care provided by the program is excluded from the employee's gross income under §105(b). However, any reward, incentive or other benefit provided by the medical program that is not a payment for or reimbursement of medical care is included in an employee's compensation income, unless excludible as an employee fringe benefit under §132. That is because under Regulation §1.105-2, the exclusion under §105(b) does not apply to amounts which a taxpayer would be entitled to receive irrespective of whether or not the taxpayer incurs expenses for medical care, including amounts paid irrespective of the amount of expense incurred by a taxpayer.

With regards to fixed indemnity health plans, the CCA noted that the amount paid is not related to the amount of any medical expense incurred or coordinated with other health coverage, so while the payment by the employer for coverage by a fixed indemnity health plan is excludible from gross income under §106, any payments by the plan are not excluded under §105(b). Moreover, to the extent the premiums are paid with pre-tax dollars through a §125 cafeteria plan or otherwise excluded from income, any payments by the plan are not excluded under §105(b) or §104(a)(3). However, to the extent that premiums are paid with after-tax dollars, payments by the plan are excluded under §104(a)(3), without regard to the amount of any medical expense incurred by the event upon which the payment is conditioned.

Thus, in Situation 1, because the premiums for the fixed indemnity health plan are included in the employee's gross income and wages (and thus paid with after-tax dollars), amounts paid by the plan are excluded from gross income and wages under §104(a)(3).

In Situation 2 and Situation 3, because the premiums for the fixed indemnity health plan are paid with amounts that are not included in the employee's gross income and wages, the exclusions under §105(b) and §104(a)(3) do not apply to the payments, and any amounts paid by the plan are included in the employee's gross income and wages.

In Situation 4 and Situation 5, because the premiums for the wellness plan are paid with amounts that are not included in the employee's gross income and wages, the exclusions under §105(b) and §104(a)(3) do not apply to the fixed indemnity cash benefit payments, and any payments are included in the employee's gross income and wages.

Chief Counsel Advice 201651013.

Trust was not entitled to a §642(c)(1) charitable deduction where the contributions to the charitable organizations were possible only because of modifications to the trust pursuant to a state court order. Further, IRS determined that the trust was not entitled to a distribution deduction under §661 to the extent of its distributable net income (DNI)) for the payments to the charities.

Grantor created the Parent Trust, a simple trust for the benefit of Child 1 and Child 2 during their respective lifetimes and then for the benefit of their respective descendants, subject to testamentary powers of appointment granted to Child 1 and Child 2 to appoint the income among Grantor's descendants, the spouses of those descendants, and charities. Child 1 died in Year 1, having exercised his power of appointment over half of the income of Parent Trust in favor of his descendants.

The trustees and beneficiaries of Parent Trust entered into a settlement agreement dividing Parent Trust into two trusts, Trust A and Trust B, for the respective benefit of Child 1's descendants and Child 2. The trustees of Trust B subsequently filed an additional petition with the state court requesting certain modifications including that Child 2 be allowed to immediately exercise an inter vivos power to appoint the trust's income and principal to private foundations, Foundation 1 and Foundation 2, and so cause Trust B to terminate. The state court approved the modification and termination, and the distribution of the trust assets to Foundations 1 and 2 was completed by the end of Year 2.

On its amended Form 1041, U.S. Income Tax Return for Estates and Trusts, Trust B claimed a charitable contribution deduction for the payments to Foundations 1 and 2. On an attachment to the amended return, Trust B claimed that the deduction was allowable under §646(c)(1) or §646(c)(2), or, alternatively, under §661.

An estate or trust (other than a simple trust) may deduct any amount of gross income, without limitation, that under the terms of the governing instrument is paid during the tax year for a charitable purpose. (§642(c)(1), Regulation §1.642(c)-1(a))

In addition, estates and certain trusts (in general, those created before October 9, 1969) are allowed to deduct any amount of gross income, without limit, which under the terms of the governing instrument is during the tax year permanently set aside for a charitable purpose. (§642(c)(2), Regulation §1.642(c)-2(a), Regulation §1.642(c)-2(b))

A trust is allowed a deduction for distributions to beneficiaries up to the DNI of the trust for the tax year. A complex trust deducts, up to its DNI ceiling for the year, the sum of: (1) any income for the tax year required to be distributed currently; and (2) any other amounts, whether income or principal, properly paid or credited or required to be distributed for that tax year. (§661(a))

A trust beneficiary must include in income the amount described in §661(a) that is paid, credited or required to be distributed by the trust to the beneficiary. (§662(a)) Any amount paid or permanently set aside or otherwise qualifying for the deduction provided in §642(c) does not fall within §661(a) or §662(a). (§663(a)(2))

Regulation §1.663(a)-2 (second sentence) provides that "[a]mounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642(c)."

In the CCA, IRS concluded that any payments to Foundations 1 and 2 after the modification of Trust B would not be considered to be made pursuant to the governing instrument, and so Trust B was not entitled to a deduction for such payments under §642(c)(1). In addition, IRS determined that Trust B was not entitled to a deduction under §661 for the payments to Foundations 1 and 2 because §642(c)(1) was the exclusive income tax provision for deductibility of payments by a trust or estate to a charitable beneficiary.

IRS rejected the taxpayer's argument, in which it cited to *Old Colony Trust Co v. Com.,* (S Ct 1937) 19 AFTR 489, that the payments qualified under §642(c) because they were pursuant to the governing instrument. In Old Colony, the Supreme Court held that, for purposes of §642(c)(1), it was not necessary that a trust deed direct charitable contributions for them to be claimed as a deduction; rather, the Court held that it was sufficient that a charitable contribution was authorized under the governing instrument.

IRS found that the taxpayer failed to address the authorities that concerned deductions under modified trust instruments.

In Revenue Ruling 59-15, 1959-1 CB 164, citing *Emanuelson, admr (Est Fitch) v. U.S.,* (DC CT 1958) 1 AFTR 2d 892 -a case in which the decedent left two conflicting wills, one which left much of the estate to charities, and one that left nothing to charities-IRS held that a settlement agreement arising from a will contest qualified as a governing instrument. In the CCA, IRS reasoned that under the facts at hand, there was no conflict with respect to Trust B subsequent to the division of Parent Trust. The terms of Trust B were unambiguous. The purpose of the court order was not to resolve a conflict in Trust B but to obtain the economic benefits which the parties believed they would receive from the modification of the Parent Trust. Neither Revenue Ruling 59-15 nor Emanuelson held that a modification to a governing instrument would be construed to be the governing instrument in situations where the modification did not stem from a conflict of some sort.

In addition, IRS noted that several cases have given a narrow interpretation of what qualifies as "pursuant to a governing instrument." In *Rebecca K. Crown Income Charitable Fund v. Com.,* (CA 7 1993) 72 AFTR 2d 93-6524, the Seventh Circuit disallowed charitable deductions where the trust instrument authorized the trustees to prepay (commute) amounts to charities only if, "as a matter of law," they could do so without adversely affecting the maximum charitable deduction. The Court found that since the trustees were required under this provision to obtain, before commuting, a private letter ruling or a judicial ruling at the appellate level establishing with reasonable certainty the propriety such action, and because they failed to do so, the contributions were not made under the terms of the trust instrument. In *Brownstone v. U.S.,* (CA 2 2006) 98 AFTR 2d 2006-6889, the Second Circuit disallowed a trust's charitable contribution deductions where the distributions were made pursuant to the wife's power of appointment and not pursuant to the governing instrument (i.e., the deceased husband's will that created the trust). The Court rejected the argument that the wife's and husband's wills could be "combined" to qualify as the governing instrument for this purpose.

Distribution deduction. While acknowledging the genuine ambiguity of §663(a)(2) and its legislative history, IRS concluded that the better overall reading of the law was to be found in the second sentence of Regulation §1.663(a)-2, which established the exclusivity of §642(c) as a deduction for charitable payments by trusts and estates.

IRS found its position was further supported by a number of other reasons, including:

a. Where a specific statute governing income tax deductions for payments to charitable beneficiaries creates a different set of rules than the general statute, the specific provision should control.

b. The basic structure of §642(c) and §2055 establishes a bifurcation in which the income of the trust or estate will be deductible, if at all, under the income tax deduction provision, and the corpus or principal will be deductible under the estate tax provision; the allowance of deductions of corpus under §661 would thus create an unintended double benefit.

c. Regulation §1.663(a)-2 was enacted shortly after the statute it interprets and has not been subsequently overturned by Congress.

PLR 201731005.

Where a taxpayer allocated his generation-skipping transfer (GST) tax exemption on the proper schedule of Form 709, but did not attach the required Notice of Allocation, he nonetheless made a proper election out of the automatic GST exemption allocation rules.

§2601 imposes a tax on every generation-skipping transfer. A generation-skipping transfer is defined under §2611(a) as: (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip. §2602 provides that the amount of the tax imposed by §2601 is the taxable amount multiplied by the applicable rate. §2641(a) defines applicable rate as the product of the maximum federal estate tax rate and the inclusion ratio with respect to the transfer.

§2631(a) provides that, for purposes of determining the inclusion ratio, every individual is allowed a GST exemption amount which may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor.

Under §2632(c)(1), if any individual makes an indirect skip during such individual's lifetime, any unused portion of such individual's GST exemption is allocated to the property transferred to the extent necessary to make the inclusion ratio for such property zero. The term "indirect skip" means any transfer of property (other than a direct skip) that is subject to the gift tax and is made to a GST trust. (§2632(c)(3)(A))

With exceptions not relevant here, that, in the case of an indirect skip, the transferor's unused GST exemption is automatically allocated to the property transferred. (Regulation §26.2632-1(b)(2)(i)) The automatic allocation is effective whether or not a Form 709 is filed reporting the transfer, and is effective as of the date of the transfer to which it relates.

An individual may elect under §2632(c)(5)(A)(i)(I) to have §2632(c) not apply to an indirect skip. An election under §2632(c)(5)(A)(i)(I) is deemed to be timely if filed on a timely filed gift tax return for the calendar year in which the transfer was made. (§2632(c)(5)(B)(i))

Under Regulation §26.2632-1(b)(2)(ii), except as otherwise provided in forms or other guidance published by IRS, the transferor may prevent the automatic allocation of GST exemption with regard to an indirect skip by making an election, as provided in Regulation §26.2632-1(b)(2)(iii). The transferor may also prevent the automatic allocation of GST exemption with regard to an indirect skip by making an affirmative allocation of GST exemption on a Form 709 filed at any time on or before the due date for timely filing, of an amount that is less than the value of the property transferred as reported on that return.

Regulation §26.2632-1(b)(2)(iii)(B) provides that, to elect out, the transferor must attach an election out statement to a Form 709 filed within the time period set out in Regulation §26.2632-1(b)(2)(iii)(C). Under Regulation §26.2632-1(b)(2)(iii)(C), to elect out, the Form 709 with the attached election out statement must, with exceptions not relevant here, be filed on or before the due date for timely filing the Form 709 for the calendar year in which the first transfer to be covered by the election out was made.

Taxpayer created Trust. Trust is an irrevocable trust for the benefit of Taxpayer's descendants. In Year 1, Taxpayer funded Trust with $a. On his Year 1 Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, Taxpayer elected out of the automatic allocation rules with respect to the gift to Trust in Year 1. He correctly reported the transfer to Trust as an indirect skip on Schedule A, Part 3. He also allocated his GST exemption to the transfer on Schedule D, Part 2, Line 6. However, he failed to attach a Notice of Allocation for this transfer.

Noting that elections may be treated as effective where the taxpayer complied with the essential requirements of a regulation (or the instructions to the applicable form), even though the taxpayer failed to comply with certain procedural directions therein, IRS held that Taxpayer's election was proper.

An election that does not strictly comply with the instructions on Form 709, or the applicable regulations, will be deemed valid if the information on the return is sufficient to indicate that the personal representative intended to make the election.

Taxpayer elected out of the automatic allocation rules for Year 1. Taxpayer could allocate his GST exemption to the Year 1 transfer by properly reporting the allocation on a timely filed Form 709. Taxpayer properly reported the allocation of GST exemption on Schedule D, Part 2, Line 6. However, Taxpayer failed to attach a Notice of Allocation in accordance with the instructions for Form 709 and thus did not literally comply with the instructions to Form 709 or the requirements in the regulations for allocating GST exemption to an indirect skip in accordance with §2632(c).

IRS concluded that the Form 709 contained sufficient information to constitute substantial compliance with the requirements of §2632(c) to allocate GST exemption to an indirect skip, and therefore Taxpayer properly allocated his GST exemption to the transfer to Trust.

PLR 201723005.

Proposed gift by the founder of a Foundation to the Foundation, by means of a transfer by a revocable trust of nonvoting interests in a new limited liability company (LLC)-the sole asset of which was a promissory note from a disqualified person with respect to Foundation-would not constitute an act of direct or indirect self-dealing under §4941.

§4941(a) imposes an excise tax on acts of self-dealing between a private foundation and any of its disqualified persons as defined in §4946. Such acts of self-dealing include any direct or indirect sale or exchange, or leasing, of property between a private foundation and a disqualified person.

Disqualified persons include: a substantial contributor to the foundation; an owner of more than a 20% interest in a substantial contributor; foundation managers; certain members of their families; and corporations, partnerships, trusts and estates in which disqualified persons own more than a 35% interest. (§4946(a)(1)) A foundation manager includes an officer, director, or trustee of a foundation. (§4946(b)(1))

Regulation §53.4941(d)-1(b)(4) provides that a transaction between a private foundation and an affiliated organization is not an indirect act of self-dealing solely because certain persons-i.e., a substantial contributors, a foundation manager, an owners of a more-than-20% interest in a substantial contributor, a member of the family of any of these persons-own 35% or less of the affiliated organization and the affiliated organization is neither: (a) controlled by the private foundation; nor (b) a corporation, partnership, estate, or trust in which such persons own a more-than-35% interest.

Regulation §53.4941(d)-1(b)(5) provides that an organization is controlled by a private foundation if the foundation or one or more of its foundation managers (acting only in such capacity) may, only by aggregating their votes or positions of authority, require the organization to engage in a transaction which, if engaged in with the private foundation, would constitute self-dealing. For these purposes, an organization will be considered to be controlled by a private foundation if the private foundation has the right to exercise veto power over the actions of such organization relevant to any potential acts of self-dealing.

In Regulation §53.4941(d)-1(b)(8), Example (1), Private Foundation owned the controlling interest of the voting stock of Corporation X, and as a result of such interest, elected a majority of its board of directors. Two of the foundation managers, A and B, who were also directors of Corporation X, formed Corp Y for the purpose of building and managing a country club. A and B received a total of 40% of Corp Y's stock, making Y a disqualified person with respect to Private Foundation under §4946(a)(1)(E). In order to finance the construction and operation of the country club, Corp Y requested and received a loan in the amount of $4 million from Corporation. The making of the loan by Corporation to Corp Y constitutes an indirect act of self-dealing between Private Foundation and Corp Y.

Regulation §53.4941(d)-2(c) provides generally that the lending of money or other extension of credit between a private foundation and a disqualified person constitutes an act of self-dealing. Thus, for example, an act of self-dealing occurs where a note, the obligor of which is a disqualified person, is transferred by a third party to a private foundation which becomes the creditor under the note.

Foundation is recognized as a §501(c)(3) organization that is a private foundation under §509(a). Foundation, which was created by Founder and her late husband, has four directors, of which three are Founder and her two sons and the fourth is an outside independent director.

Founder sold membership interests in First LLC to Irrevocable Trust in exchange for a promissory note. Founder's descendants were beneficiaries of Irrevocable Trust. Founder desired that, following her death, any part of the principal and interest on the promissory note which remained then unpaid would be used to benefit Foundation.

To accomplish this goal, Founder contributed and transferred the promissory note to New LLC in exchange for voting and nonvoting interests, which subsequently were transferred to Revocable Trust. Founder was the settlor and sole trustee of Revocable Trust and held a revocation power in the form of a power to direct the trustee to distribute the assets of the trust to her during her lifetime. Founder's descendants were beneficiaries of Revocable Trust.

New LLC will hold and administer the promissory note and receive payments of interest and principal on it. New LLC's sole asset and source of income is, and will be, the promissory note. Power to manage the affairs of New LLC is vested in the manager, who is selected and may be removed by the members holding voting interests in New LLC. One of Founder's sons, who is also a director of Foundation, is the sole manager of New LLC. The members holding nonvoting interests possess no management rights or rights to vote on the manager of New LLC. New LLC may only be dissolved with written approval of all members, whether holding voting or nonvoting interests.

Founder proposes that at the time of her death, Revocable Trust (which will become irrevocable at that time) will distribute to Foundation all of the nonvoting interests in New LLC, which have a profit-sharing ratio of 99%. Revocable Trust will retain its voting interests in New LLC, which have a profit-sharing ratio of 1%.

In the Private Letter Ruling (PLR), IRS concluded, based solely on the facts and representations submitted, that Founder's proposed gift to Foundation by means of a transfer by Revocable Trust of nonvoting interests in New LLC-the sole asset of which is a promissory note from a disqualified person with respect to Foundation-will not constitute an act of direct or indirect self-dealing under §4941.

IRS reasoned that Irrevocable Trust and Revocable Trust are disqualified persons under §4946(a)(1)(G) with respect to Foundation because they are trusts in which Founder's descendants-who are disqualified persons under §4946(a)(1)(D) with respect to Foundation-hold more than a 35% beneficial interest. Irrevocable Trust is the obligor of a promissory note that was held by Founder. Founder desired that, following her death, any unpaid principal and interest on the promissory note be used to benefit Foundation. Under Regulation §53.4941(d)-2(c), if Founder transferred the promissory note to Foundation, which would become creditor under the note, there would be an act of self-dealing.

Instead, Founder contributed and transferred her ownership of the promissory note to New LLC. At Founder's death, Foundation will acquire the nonvoting interests in New LLC, which will have a profit-sharing ratio of 99%, by gift through a distribution from Revocable Trust, rather than through a self-dealing transaction. If Foundation was to "control" New LLC within the meaning of Regulation §53.4941(d)-1(b)(5), then Foundation would be indirectly serving as the creditor under the note by reason of its ownership interest. See Regulation §53.4941(d)-1(b)(8), Example (1). However, Foundation will not "control" New LLC under Regulation §53.4941(d)-1(b)(5) due to a lack of voting power.

As holder of the nonvoting interests, Foundation will have no management rights or right to vote on the manager of New LLC. Revocable Trust (which will have become irrevocable at Founder's death) will own all of the voting interests, giving Revocable Trust the right to select and remove the manager of New LLC. As a holder of nonvoting interests, Foundation will have a right to receive distributions only if New LLC dissolves or chooses to make current distributions, but the timing and amount of such distributions will be uncertain and could not be compelled by Foundation. Only Revocable Trust as the holder of the voting interests may elect or remove the manager of New LLC, and such manager will have the sole power to manage the affairs of New LLC and determine the timing and amount of distributions. Thus, Foundation and Foundation's managers (acting only in such capacity) will not have sufficient votes or positions of authority to cause New LLC to engage in a transaction.

In addition, Foundation will not have the power to compel dissolution of New LLC since New LLC may only be dissolved with written approval of all members, including Revocable Trust. The power associated with the nonvoting interests of New LLC as a necessary party to vote on the liquidation of the LLC is not considered equivalent to a "veto power" under Regulation §53.4941(d)-1(b)(5) because the power cannot be exercised over an action relevant to any potential act of self-dealing.

Accordingly, Foundation's receipt from Revocable Trust upon Founder's death of nonvoting interests in New LLC will not constitute a loan or extension of credit between a private foundation and a disqualified person under §4941(d)(1) and Regulation §53.4941(d)-2(c) because Foundation will not acquire an interest in the promissory note. Instead, Foundation will acquire nonvoting interests in New LLC, with respect to which it will not have any management rights or control over distributions.

Thus, Founder's proposed transfer of nonvoting interests in New LLC to Foundation will not constitute an act of self-dealing under §4941.

PLR 201722014.

Certain options given to public hospital employees affected by a lay-off or privatization of their hospital constitute a cash or deferred plan. The ruling also provided guidance on what IRS does and does not consider "hypothetical" for purposes of Revenue Procedure 2017-1 's provision that IRS will not issue rulings on hypothetical situations.

Regulation §1.401(k)-1(a)(2)(i) defines a "cash or deferred arrangement" as, except as otherwise provided, an arrangement under which an eligible employee may make a cash or deferred election with respect to contributions to, or accruals or other benefits under, a plan that is intended to satisfy the requirements of §401(a).

Regulation §1.401(k)-1(a)(3)(i) provides that a "cash or deferred election" is any direct or indirect election (or modification of an earlier election) by an employee to have the employer either provide an amount to the employee in the form of cash (or some other taxable benefit) that is not currently available, or contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation.

Regulation §1.401(k)-1(a)(1) provides that a plan, other than a profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan, does not satisfy the requirements of 401(a) if the plan includes a cash or deferred arrangement. For this purpose, a cash or deferred arrangement is part of a plan if any contributions to the plan, or accruals or other benefits under the plan, are made or provided pursuant to the cash or deferred arrangement.

In January of each year, IRS issues a Revenue Procedure that sets out rules for private letter rulings, closing agreements and determination letters. The most recent such Revenue Procedure is Revenue Procedure 2017-1, 2017-1 IRB 1. Revenue Procedure 2017-1, §6 covers circumstances under which IRS will not issue a ruling. Included in Revenue Procedure 2017-1, §6, are Revenue Procedure 2017-1, §6.02, which provides that IRS may decline to issue a letter ruling when appropriate in the interest of sound tax administration, and Revenue Procedure 2017-1, §6.12, which provides that IRS will not issue a letter ruling on hypothetical situations.

The Plan is a governmental defined benefit pension plan under §414(d). The Plan covers the employees of every department and agency of the State, including its public hospitals.

In anticipation of the State privatizing or closing its public hospitals, State enacted Statute. Due to a legal challenge, Statute is not currently effective, pending the outcome of the legal challenge. Statute provides that employees of the State's public hospitals whose positions are being abolished or who are directly affected by a reduction-in-force or workforce restructuring plan, including privatization, could, in lieu of exercising their reduction-in-force rights under State law, elect one of the following:

a. Voluntary severance benefit-a one-time lump-sum cash payment of a percentage of base salary per year of service worked, not to exceed a certain amount; or

b. Special retirement benefit-a subsidized early retirement benefit under the Plan that would permit the employee to retire with an unreduced retirement benefit at an earlier age or with less service than previously permitted under the Plan.

Observation: The PLR does not spell out that the "reduction-in-force rights" mentioned above involve the Plan, but it is clear from the rest of the PLR that those rights do involve the Plan.

The options constitute a cash or deferred arrangement. IRS concluded that the options in Statute constitute a cash or deferred arrangement.

The election permitted by Statute allows an employee who is already a participant in the Plan to choose either (a) the voluntary severance benefit, or (b) a subsidized early retirement benefit. The voluntary severance benefit provides an amount of cash (or other taxable benefit) that is not currently available. The early retirement benefit provides an accrual or other benefit under a plan deferring the receipt of compensation. For this purpose, the term "other benefit" in Regulation §1.401(k)-1(a)(3)(i) covers a wide variety of potential benefits, and includes a subsidized early retirement benefit that is paid under a pension plan and that an employee would otherwise not be eligible to receive.

Accordingly, if Statute becomes effective, the election granted to the State employees under Statute with respect to the benefit they receive upon separation from service would constitute a cash or deferred election within the meaning of Regulation §1.401(k)-1(a)(3)(i) because it is an election between an amount in the form of cash (or some other taxable benefit) that is not currently available, and an accrual or other benefit under a plan deferring the receipt of compensation. Because the election would constitute a cash or deferred election, it creates a cash or deferred arrangement within the meaning of Regulation §1.401(k)-1(a)(2)(i).

Under Regulation §1.401(k)-1(a)(1), because Statute, if it becomes effective, would create a "cash or deferred arrangement," the Plan, which is a defined benefit plan (and not a profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan), would not satisfy the qualification requirements of 401(a) because it would include a cash or deferred arrangement.

In accordance with Revenue Procedure 2017-1, §6.02 and Revenue Procedure 2017-1, §6.12, IRS declined to rule on the Federal tax consequences, to the Plan and its members and beneficiaries, of disqualification of the Plan, because such a ruling would involve facts pertaining to taxpayers other than the Plan and would be hypothetical given that Statute is not currently effective and may never become effective.

Observation: Thus, while all three of the issues in the PLR involve the Statute, which is not currently effective, IRS only considered the third issue-the issue involving tax consequences of the loss of qualified plan status-as hypothetical and thus on a subject for which a ruling could not be issued.

PLR 201720010.

Adverse §501(c)(3) tax-exempt determination to an organization using open source software to develop a news co-op model for community level internet journalism and news. IRS determined that the organization was not operated exclusively for one or more of the purposes specified in §501(c)(3). A substantial activity of the organization was the providing, licensing, and support of a software program, for a fee, to unrelated organizations that were not tax exempt.

To qualify for tax exemption under §501(c)(3), an organization must be organized and operated exclusively for religious, charitable, scientific, public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals. (Regulation §1.501(c)(3)-1(a)(1))

An organization is regarded as operated exclusively for an exempt purpose only if it: (1) engages primarily in activities that accomplish one or more exempt purposes, (2) has no part of its net earnings inure to the benefit of private shareholders or individuals, and (3) is not an "action" organization (described in Regulation §1.501(c)(3)-1(c)(1))-collectively, the operational test. (Regulation §1.501(c)(3)-1(c)) An organization is not organized or operated exclusively for one or more of the specified exempt purposes unless it serves a public rather than a private interest. (Regulation §1.501(c)(3)-1(d)(1)(ii))

In *Better Business Bureau of Washington, D.C., Inc. v. U.S.* (S Ct 1945) 34 AFTR 5, the Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy a claim for exemption regardless of the number or importance of truly exempt purposes.

In *Forest Press Inc.,* (1954) 22 TC 265, the Tax Court determined that an organization devoted to developing and propagating the use of the Dewey Decimal Classification System and Related Index was a charitable organization. By the time Forest Press was formed, the System had been adopted by more than 90% of U.S. libraries to classify and index their collections and was in use in 42 countries. Thus, the court concluded that the System was an important aid to education and research and not a commercial enterprise.

In Revenue Ruling 72-369, 1972-2 CB 245, IRS held that an organization formed to provide managerial and consulting services at cost to unrelated §501(c)(3) organizations was itself not exempt under §501(c)(3). IRS reasoned that providing managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit, and the fact that the services were provided at cost and solely for exempt organizations was not sufficient to characterize the activity as charitable.

In *B.S.W. Group, Inc.,* (1978) 70 TC 352, the Tax Court concluded that a corporation formed to provide consulting services to nonprofit organizations was not exempt under §501(c)(3) because its activities constituted the conduct of a trade or business that is ordinarily carried on by commercial ventures organized for profit. Its primary purpose was not charitable, educational, nor scientific, but rather commercial; and its only source of income was from fees which were set high enough to recoup all projected costs and produce a profit. And finally, the corporation had failed to limit its clientele to organizations that were §501(c)(3) exempt organizations.

In *Easter House v. U.S.,* (Cl Ct 1987) 60 AFTR 2d 87-5119, the Claims Court found that an organization providing adoption services to parents seeking to adopt a child for a fee (its only source of income) did not qualify for an exemption under §501(c)(3). The Court determined that the organization competed with other commercial organizations providing similar services. The Court concluded that the organization's business purpose of operating an adoption service, not the advancement of educational and charitable activities, was its primary goal.

Organization was formed by Articles of Incorporation that stated that it aimed to strengthen communities that were ill-served by existing media, specifically by broadening the informed electorate by publishing original journalism that provides civic education for the less-than-affluent public. Previously, Organization, which had as its primary activity the provision of publishing open source software for community internet news sites, applied for exemption under §501(c)(3) and was denied.

Organization submitted a new Form 1023 (Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code) which, along with its bylaws, indicated that its mission had changed to providing mentorship and educational and administrative support to independent journalism initiatives across the U.S. to serve the growing number of communities that lack the robust sources of information that people need to make sound citizenship decisions. Its main focus was on civic learning initiatives that sought to (1) educate citizens in these communities regarding current events of significance and the workings of government and other civic institutions, and (2) strengthen the civic life of these underserved communities.

To accomplish this mission, Organization developed a news co-op model for community level internet journalism and news. It developed educational materials including a comprehensive guide for creating news co-ops, templates for business planning, and plans for enrolling founding members, all supported by its staff's guidance.

Organization provided open source software in the form of the P platform to community groups (affiliates) who operated as co-ops to produce on line news sites. The software enabled web based news sites to: (a) invite readers to collaborate with editors in the news-gathering process, to engage with other readers in pursuit of civic goals, and to become members of the news sites, and (b) provide automated bookkeeping and membership tracking so that news sites can put maximum effort into covering their community's news and be less burdened by administration.

Organization charged its affiliates an upfront fee for hosting of the affiliate's preliminary website and IT support and an annual fee based on a percentage of their gross revenues in order to partly offset its costs of services, travel, and related administration.

In the PLR, IRS determined that Organization did not qualify for exemption under §501(c)(3). It concluded that Organization failed to show that it met the operational test under Regulation §1.501(c)(3)-1(a)(1). Although Organization may have had some educational activities, like the organization described in Better Business Bureau, a substantial portion of its activities was providing services for a fee to co-op news organizations that it helped establish. Consequently, it was not operating exclusively for §501(c)(3) purposes.

Organization was similar to the organizations in B.S.W. Group, Inc. and Easter House. Organization developed and distributed software to non-exempt entities that would pay for the software and its support through annual fees. Its activities competed with other commercial publishing software developers and distributors. Such competition provided Organization's activities with a commercial hue. More than an insubstantial part of its activities were not in furtherance of charitable or educational purposes, or other exempt purposes which precluded it from exemption under §501(c)(3).

Similar to the organization in Revenue Ruling 72-369, Organization was providing services on a regular basis for a fee in a manner similar to a trade or business. Moreover, its services for a fee were focused on community groups organized as news co-ops, unlike the organization in Revenue Ruling 72-369 that focused on unrelated tax exempt organizations.

Organization did not show-as required by Regulation §1.501(c)(3)-1(c)(1) -that it was primarily engaged in activities which accomplish one or more of the exempt purposes specified in §501(c)(3). Organization provided open source software in the form of the P platform, while providing consulting and technical services for a startup fee and ongoing technical support services for a percentage of the organizations' gross revenue. IRS found that Organization's activities were best described as providing a product with product information analogous to a product manual. Such indicated that it was operating for substantial nonexempt purposes.

IRS concluded that Organization was not like the organization in Forest Press Inc., which had as its primary activity the continued development and propagation of the Dewey Decimal Classification System-an important aid to education and research. IRS concluded that by providing its software tailored to each news co-op's needs, Organization's activities were neither educational nor comparable to promoting the Dewey Decimal Classification System. Furthermore, Organization did not limit distribution of its programs. Its only control over the news co-op was a check to assure it upheld its values that the journalism published was relevant to the less-than-affluent readership. The programs were also available to all organizations, commercial or otherwise.

Organization was not operated exclusively for exempt purposes-as required by Regulation §1.501(c)(3)-1(d)(1)(ii) -because it served private rather than public interests. IRS found that Organization had no operational control over the affiliate co-ops who would operate independent on-line news sites, indicating that Organization was operating for their private interests and so precluding it from an exemption under §501(c)(3).

PLR 201720009.

Various circumstances in which a government entity employer "picks up" mandatory employee contributions to employer plans that qualify under §401(a) and found that, in each of the circumstances, the amounts picked up by the employer qualify as employer contributions.

Regulation §1.402(a)-1(a)(1)(i) provides, in pertinent part, that if an employer makes a contribution for the benefit of an employee to a trust described in §401(a) that is exempt under §501(a), the employee is not required to include such contribution in his or her income except for the year or years in which such contribution is distributed to him or her. A governmental plan, as defined in §414(d), is a type of plan that is exempt under §501(a).

Under §414(h)(1), any amount contributed to an employees' trust described in §401(a) will not be treated as having been made by the employer if it is designated as an employee contribution. However, §414(h)(2) provides that, for purposes of §414(h)(1), in the case of any plan established by the government of any State, political subdivision thereof, etc., where the contributions of employing units are designated as employee contributions but where any employing unit picks up the contributions, the contributions so picked up will be treated as employer contributions.

§3401(a) provides the definition of wages for purposes of federal income tax withholding. §3401(a)(12)(A) provides, in part, an exception from wages for employer contributions paid on behalf of an employee or his beneficiary to a trust described in §401(a) that is exempt from tax under §501(a).

The federal income tax treatment of contributions that are picked up by the employer within the meaning of §414(h)(2) has been developed in a series of revenue rulings. In Revenue Ruling 77-462, 1977-2 CB 358, the employer school district agreed to assume and pay the amounts employees were required by state law to contribute to a state pension plan. Revenue Ruling 77-462 concluded that the school district's picked-up contributions to the plan were excluded from the employees' gross income until such time as they were distributed or made available to the employees. The revenue ruling also held that, under the provisions of §3401(a)(12)(A), the school district's contributions to the plan were excluded from wages for purposes of the collection of income tax at the source on wages. Therefore, no withholding was required for federal income tax purposes from the employees' salaries with respect to such picked-up contributions.

Revenue Ruling 2006-43, 2006-35 IRB 329, describes the actions required for a state, political subdivision of a state, etc. to pick up employee contributions to a plan qualified under §401(a) so that the contributions are treated as employer contributions pursuant to §414(h)(2). Revenue Ruling 2006-43 provides that a contribution to a qualified plan established by an eligible employer (that is, a governmental employer) will be treated as picked up by the employing unit under §414(h)(2) if two conditions are satisfied:

1. First, the employing unit must specify that the contributions, although designated as employee contributions, are being paid by the employer. For this purpose, the employing unit must take

formal action to provide that the contributions on behalf of a specific class of employees of the employing unit, although designated as employee contributions, will be paid by the employing unit in lieu of employee contributions. A person duly authorized to take such action with respect to the employing unit must take such action. The action must apply only prospectively and be evidenced by a contemporaneous written document (e.g., minutes of a meeting, a resolution, or ordinance).

2. Second, the pick-up arrangement must not permit a participating employee from and after the date of the pick-up to have a cash or deferred election right within the meaning of Regulation §1.401(k)-1(a)(3) with respect to designated employee contributions. Thus, for example, no participating employee may be given the right to opt out of the pick-up arrangement described in §414(h)(2) or to receive the contributed amounts directly instead of having them paid by the employing unit to the plan.

Revenue Ruling 2006-43 also states that the pick-up rules apply even if the employer picks up contributions through a reduction in salary or through an offset against future salary increases.

State B established Plans X, H, and O, which are intended to qualify under §401(a) as applicable to governmental plans as defined in §414(d). System S, an instrumentality of State B, is the general administrator of Plans X and H (the "System S plans").

Plan X is a defined benefit plan that provides retirement benefits to employees of State B and political subdivisions of State B electing to participate in the plan. Membership in Plan X is a condition for employment for full-time state employees and employees of participating political subdivisions of State B who enter service on or before June 30, 2014.

Plan X generally requires mandatory employee contributions of 5% of earnable compensation. However, for state employees who become members of Plan X on or after July 1, 1981, but before July 1, 2014, the State assumes mandatory employee contributions up to 5% of the employees' earnable compensation. In addition, political subdivisions of State B that become participating employers in Plan X may also assume mandatory employee contributions up to 5% of the employees' earnable compensation. Mandatory employee contributions to Plan X are currently picked up under §414(h)(2) in accordance with a private letter ruling issued to State B in 1986.

Plan H is a defined benefit plan with a defined contribution component providing retirement benefits to state employees and employees of participating political subdivisions. All state employees who are hired on or after July 1, 2014, are required to participate in Plan H as a condition of employment. Mandatory employee contributions to Plan H are set at 5% of the employees' earnable compensation. Pursuant to the State B statute establishing Plan H, mandatory employee contributions to Plan H are currently picked up under §414(h)(2).

Plan O is a defined contribution retirement plan for higher education employees who are exempt from the Fair Labor Standards Act. For higher education employees hired prior to July 1, 2014, State B assumes employee contributions up to 5% of the employees' earnable compensation, and such employees may elect to participate in Plan O in lieu of System S plans. Higher education employees hired on or after July 1, 2014, may elect to participate in Plan O in lieu of Plan H and are subject to mandatory employee contributions at the rate of 5% of the employees' earnable compensation under either Plan O or Plan H. Such mandatory contributions are currently picked up under §414(h)(2) in accordance with a State B statute.

Plan X, Plan H, and Plan O provide that the mandatory employee contributions that are picked up will be treated as employer contributions pursuant to §414(h)(2), that employee contributions will be paid by the employer in lieu of contributions by the employee, and that the employee will not have the option of choosing to receive the contributions in the form of cash or cash equivalents instead of having them paid by the employer into the plan in which the employee participates.

Political subdivisions of State B are not required to participate in System S. Certain political subdivisions of State B maintain Closed Plans that are defined benefit plans established either prior to the establishment of System S or in lieu of participation in System S. A political subdivision of State B may elect to participate in System S by executing an adoption resolution prior to the political subdivision participating in System S as an employer.

Political subdivisions of State B that are not otherwise participating in Plan X may adopt a resolution to participate in Plan H, and political subdivisions of State B that are already participating in Plan X may adopt a resolution to change their participation prospectively to Plan H, but only with regard to their employees hired on or after July 1, 2012. Employees of political subdivisions of State B may elect to transfer membership from the Closed Plans to Plan X or Plan H. However, if the Closed Plan of the political subdivision does not have a mandatory employee contribution equal to 5%, as required by both Plan X and Plan H, the political subdivision must set the employee contribution to the same contribution rate under Plan X and Plan H as it was under the political subdivision's Closed Plan.

Political subdivision employees currently participating in Plan X may transfer their membership to Plan H. Employee contributions to Plan H remain at the same rate for employees who switch membership.

In all instances, the election to transfer from one plan to another is only available to an employee for whom the mandatory employee contribution rate will remain the same before and after the employee's transfer between plans.

The ruling held that:

1. If current employees of political subdivisions that are participating employers in Plan H elect to transfer on a prospective basis from Plan X to Plan H, the mandatory employee contributions that are picked up by the participating employer will be treated as employer contributions pursuant to a valid pick-up under §414(h)(2).

2. If current employees of political subdivisions elect to switch from any of the Closed Plans to Plan X or Plan H, the mandatory employee contributions that are picked up by the participating employer will be treated as employer contributions pursuant to a valid pick-up under §414(h)(2).

3. If certain higher education employees elect to participate in Plan H or Plan O upon their initial date of hire, the mandatory employee contributions that are picked up by State B as the participating employer will be treated as employer contributions pursuant to a valid pick-up under §414(h)(2).

4. The mandatory employee contributions made pursuant to ruling requests (1)-(3) above and picked up by the employer will not be included in employees' gross income for federal income tax purposes until distributed.

5. The mandatory contributions made pursuant to rulings requests (1)-(3) above and picked up by the employer will not constitute wages subject to federal income tax withholding under §3401(a).

It provided its reasoning for each of these conclusions, including the following:

With respect to the first ruling request, the mandatory contributions to Plan X and Plan H satisfy the criteria for picked-up contributions set forth in Revenue Ruling 2006-43. The taxpayer has previously received a private letter ruling on the validity of Plan X's pick-up arrangement. Plan H currently provides that each employer will pick up the mandatory employee contributions to Plan H. State B took formal action by enacting a statute providing that mandatory employee contributions to Plan H, although designated as employee contributions, will be paid by the employing unit in lieu of employee contributions. No provision of Plan X or Plan H permits employees the option to choose to receive the contributed amounts directly instead of having them paid by the participating employer to Plan X or Plan H. Because the rate of the contribution is the same regardless of whether an employee is a participant in Plan X or Plan H, there is no cash or deferred election with respect to the contributions.

With respect to the fifth ruling, because IRS determined that the picked-up amounts in ruling requests (1)-(3) are to be treated as employer contributions, and based on §3401(a)(12)(A) and Revenue Ruling 77-462, it concluded that the contributions described in ruling requests (1)-(3) that are picked up as employer contributions under §414(h)(2)) are excluded from wages for purposes of federal income tax withholding.

Without deciding whether the pick-up contributions are made pursuant to a salary reduction agreement for FICA tax purposes, the ruling summarizes the relevant law.

In general, all payments of remuneration by an employer for services performed by an employee are subject to FICA taxes unless the payments are specifically excepted from the term "wages" or the services are specifically excepted from the term "employment." FICA taxes include social security and Medicare taxes. Under §3121(v)(1)(B), if an employee's services are covered for social security tax purposes, pickup contributions under §414(h)(2) that are made pursuant to a salary reduction agreement are generally subject to social security taxes (unless the maximum wage base exception applies). For these purposes, the term "salary reduction agreement" includes any salary reduction arrangement, regardless of whether there is approval or choice of participation by individual employees or whether such approval or choice is mandated by State statute. (H.R. Conf. Rep. No. 861, (1984); *Public Employees' Retirement Board,* (CA 10 1998) 82 AFTR 2d 98-6072) Also, under §3121(v)(1)(B), if an employee's services are covered for Medicare tax purposes, pick-up contributions under §414(h)(2) that are made pursuant to a salary reduction agreement are subject to Medicare taxes (without any limit based on the amount of wages).

PLR 201715001.

Annual additions made by or on behalf of a taxpayer to a plan maintained by an entity in which he was the sole owner and employee, and to a plan maintained by an entity in which he owned an interest through another solely owned entity, had to be aggregated under §414(c). The TAM reasoned that the two solely owned entities had to be treated as a single employer for purposes of the §415(c) limit on annual additions to a defined contribution plan and that the cumulative additions to the two plans violated these limits.

Under §414(c), all employees of trades or businesses, whether or not incorporated, which are under common control are generally treated as employed by a single employer for a variety of purposes, including limitations on benefits and contributions under §415. §415(c) limits annual additions under a defined contribution plan to the lesser of an inflation-adjusted dollar amount ($50,000 in 2012) or 100% of the participant's compensation.

Regulation §1.414(c)-2 provides that two or more trades or businesses under common control includes a brother-sister controlled group-i.e., two or more organizations conducting trades or businesses if (i) the same five or fewer persons own a controlling interest in each organization (at least 80%) and (ii) taking into account these interests only to the extent they are identical, have effective control (more than 50%).

§414(m) was enacted in 1980 to aggregate certain entities that did not have sufficient common ownership to form a controlled group. It provides that all members of an "affiliated service group" must be aggregated for purposes of the employee benefit requirements under a number of Code provisions, including §415. An affiliated service group is a group consisting of a First Service Organization (FSO) whose principal business is providing services, and at least one other related organization. (§414(m)(2)) Proposed regulations issued under §414(m)(2) in 1983 provided that where aggregation is required under §414(b) (relating to a controlled group of corporations) or §414(c), and is also required under §414(m), then the requirements with respect to all of the applicable provisions must be satisfied-in other words, the §414(m) rules apply in addition to the aggregation rules for commonly controlled corporations and other commonly controlled trades or businesses. (Proposed Regulation §1.414(m)-1(a))

All employees of controlled groups under §414(b) or §414(c) are treated as employed by a single employer so that a plan maintained by any member is deemed maintained by all of the members. (Regulation §1.415(a)-1(f)(1)) Any plan maintained by a member of an affiliated service group is deemed maintained by all members of that affiliated service group. (Regulation §1.415(a)-1(f)(2))

Taxpayer is the sole owner and employee of Entity 1 and Entity 2, which are in a §414(c) brother-sister controlled group. Entity 2 is also a partner in Entity 3 along with professional corporations and two individuals. Taxpayer is also a partner as an individual in a related organization, Entity 4, with the same partners. Entities 2, 3, and 4, and the other professional corporations that are partners in Entity 3, constitute an affiliated service group, Entity 5, under §414(m)(2)(A). Both Entity 3 and Entity 4 have staff employees.

Entity 1 maintains Plan A, in which Taxpayer is the sole participant. Entity 3 sponsors Plan B, a volume submitter profit-sharing plan with a cash or deferred arrangement. Entity 2 is one of the participating employers in Plan B, so Taxpayer is participating in Plan B as the sole employee of Entity 2.

The majority of partners of Entity 3 participate in Plan B through their professional corporations. The staff employees of Entities 3 and 4 also participate in Plan B.

In 2012, Taxpayer contributed an undisclosed amount to Plan A in 2012 and also made elective contributions to Plan B (consisting of both elective deferrals and catch-up contributions). In addition, Entity 2 made matching contributions and profit sharing contributions to Plan B on Taxpayer's behalf. The contributions to the two plans exceeded the annual limitation for 2012.

The TAM addressed whether the annual additions credited to Taxpayer's accounts in Plans A and B are required to be aggregated for purposes of §415(c)(1) due to the application of the controlled group rules under §414(c).

Taxpayer argued that Entity 1 and Entity 2 are not in a controlled group for purposes of determining the §415(c) limits for Plans A and B. According to Taxpayer, because Entity 2 is a part of Entity 5 (an affiliated service group under §414(m)), Entity 5 should be treated as the single employer maintaining Plan B; and Entity 1 does not have a sufficient relationship with Entity 5 to be treated as a single employer in a controlled group with Entity 5 under §414(c). Thus, asserted Taxpayer, separate limitations apply to the two plans.

Taxpayer also argued that he could have had two separate §415(c) limits if he owned the partnership interests of Entity 3 as an individual rather than through Entity 2, and that reaching a different result because Entity 2 is the partner in Entity 3 rather than Taxpayer amounts to form over substance.

The TAM determined that Entity 1 and Entity 2 are in a controlled group and are treated as a single employer under §414(c), so the Plan A and Plan B contributions must be combined under one §415(c) limit. IRS reasoned that the result does not change simply because Entity 2 is also in an affiliated service group under §414(m) as part of Entity 5. IRS noted that, while there are situations in which entities can avoid the aggregation requirements (e.g., §414(r)), none applied in this case.

IRS further concluded that requiring aggregation is consistent with Proposed Regulation §1.414(m)-1(a), which provides that if aggregation is required under either §414(b) or §414(c) and also under §414(m), the requirements with respect to all of the applicable provisions must be satisfied. This result was also consistent with the legislative history underlying §414(m).

IRS rejected Taxpayer's argument that Entity 5 should be treated as the single employer maintaining Plan B. As noted above, §414(c) and §414(m) must both be met in their entirety. Therefore, while all employers in Entity 5 are treated as a single employer under §414(m)(1) for §415(c) purposes, Entity 1 and Entity 2 are also treated as a single employer under §414(c) for §415(c) purposes. And it is with respect to the controlled group under §414(c) involving Entity 1 and Entity 2 that Taxpayer exceeded the limitations under §415(c).

IRS also rejected Taxpayer's form-over-substance argument, noting that Entity 2 is an entity in its own right, that it performs functions an employer would perform, and that Taxpayer chose to have Entity 2 participate as the partner in Entity 3.

PLR 201707001.

Surviving spouse could roll over her deceased spouse's Roth IRAs and regular IRA, payable to a trust of which she was sole trustee and beneficiary, into her own Roth IRA and regular IRA. By making the rollovers, the spouse avoided having to take lifetime required minimum distributions (RMDs) from the Roth IRAs and was treated as the owner of the regular IRA for purposes of computing lifetime RMDs from that account.

A surviving spouse designated as the beneficiary of an IRA need not leave the IRA in the decedent's name. The surviving spouse can either:

1. Roll over the decedent's IRA into an IRA in the spouse's name (§408(d)(3)(C)(ii)(II)), or

2. Elect to treat the decedent's IRA as the spouse's own IRA. (Regulation §1.408-8, Q&A 5(a))

Observation: There is much to gain by choosing one of these options. For example, the surviving spouse can designate his or her own beneficiaries. And the surviving spouse can compute RMDs as if he or she had funded the receiving IRA, generally resulting in a longer payout than would be the result if the surviving spouse were treated as the beneficiary (rather than the owner of) the decedent's IRA.

The election to treat the decedent's IRA as the surviving spouse beneficiary's IRA is available only if the spouse is "the sole beneficiary" of the IRA and has an unlimited right to withdraw amounts from it. The sole beneficiary requirement is not met if a trust is named as the IRA's beneficiary, even if the spouse is the sole beneficiary of the trust. (Regulation §1.408-8, Q&A 5(a))

There is no immediate tax if distributions from an IRA are rolled over to an IRA or other eligible retirement plan (i.e., qualified trust, governmental §457 plan, §403(a) annuity or §403(b) tax-sheltered annuity). For the rollover to be tax-free, the amount distributed from the IRA generally must be recontributed to the IRA or other eligible retirement plan no later than 60 days after the date that the taxpayer received the withdrawal from the IRA. (§408(d)(3)) A distribution rolled over after the 60-day period generally will be taxed (and also may be subject to a 10% premature withdrawal penalty tax). (§72(t)) Under §408(d)(3)(B), an individual is permitted to make only one nontaxable 60-day rollover between IRAs in any 1-year period.

In the case of an inherited IRA, §408(d)(3) does not apply to any amount received by an individual from such an account, and the inherited account is not treated as an IRA for purposes of determining whether any other amount is a rollover contribution. (§408(d)(3)(C)(i)) An IRA is treated as inherited if the individual for whose benefit the account is maintained acquired the account by reason of the death of another individual, and that individual was not the surviving spouse of such other individual. (§408(d)(3)(C)(ii))

A Roth IRA generally is treated in the same way as a traditional IRA, but the RMD rules do not apply before the death of the Roth IRA owner. (§408A(c)(5)(A)).

Observation: In other words, a Roth IRA owner is not required to take RMDs during his or her lifetime. However, the beneficiary of a Roth IRA is required to take RMDs after the Roth IRA owner dies.

The only rollover contribution permitted to a Roth IRA is a qualified rollover contribution, generally one that is a rollover to a Roth IRA from another Roth IRA. (§408A(a)(6)) Under §408A(e)(1), a qualified rollover from an individual retirement plan other than a Roth IRA to a Roth IRA is disregarded for purposes of the one-rollover-per-year rule of §408(d)(3)(B).

Decedent died owning seven Roth IRAs and one traditional IRA, all of which were treated as property held in a revocable trust (Trust) having Decedent and Spouse as sole trustees. Upon Decedent's death, Spouse became the sole trustee of the Trust and three subtrusts that arose upon Decedent's death. The Trust vests Spouse with complete authority and sole control in allocating assets to the subtrusts.

The first subtrust is the Survivor's Trust. Spouse, as sole trustee, is to allocate her separate property and a portion of the trust estate corresponding to her community property interest in the trust estate to the Survivor's Trust. During her life, she is entitled to the income and principal of the Survivor's Trust up to and including the entire trust estate of the Survivor's Trust.

Upon Spouse's death, any remaining assets will be added to the second subtrust, the Bypass Trust. Spouse, as trustee, is to allocate an amount based on a formula designed to minimize federal estate tax to this Trust, and the balance of the Trust's assets are to be allocated to the third subtrust, the Marital Trust.

During Spouse's life, she is entitled to all of the income from the Bypass Trust and the Marital Trust as well as such amounts of principal as are necessary for her health, education, support and maintenance, except that the distributions of principal from the Marital Trust cannot occur unless and until the Survivor's Trust has no readily marketable assets remaining. Distributions of principal from the Bypass Trust cannot occur until both the Survivor's Trust and the Marital Trust have no readily marketable assets remaining. Spouse is also required to receive any IRA distributions that are paid to either the Bypass Trust or the Marital Trust.

Upon Spouse's death, remaining assets in the Marital Trust will be distributed to the Bypass Trust, and the Bypass Trust will pass to two adult children. Also, under the terms of the Trust, upon Decedent's death, the Trust became irrevocable except with respect to the Survivor's Trust.

Spouse and Decedent communicated to their attorney that they wanted Spouse to have the flexibility to elect to treat Decedent's IRAs as her own if she was the surviving spouse. For four of the Roth IRAs, the attorney caused death beneficiary designation forms to name the Trust as beneficiary. It was Spouse's understanding that she could achieve a spousal rollover of these amounts by first allocating them to the Survivor's Trust. For the other three Roth IRAs and the traditional IRA, the Marital Trust was named beneficiary. But the Trust does not grant Spouse the authority to reallocate amounts from the Marital Trust to the Survivor's Trust.

To remedy her situation, Spouse obtained an order from Court reforming the Marital Trust beneficiary designations, retroactive to their original execution date, to show the Trust as the primary beneficiary. Pursuant to the order, Spouse allocated the entirety of four of the Roth IRAs to the Survivor's Trust and half of each of the other three Roth IRAs and half of the traditional IRA to the Survivor's Trust, with the remaining half of each of those IRAs being allocated to the Marital Trust.

Spouse intends to set up and maintain a Roth IRA in her name and a traditional IRA in her name to take a distribution of the traditional IRA and the Roth IRAs held by the Survivor's Trust. She wants to roll over the portion of the distribution consisting of Roth IRA assets to the custodian of her Roth IRA and the portion of the distribution consisting of traditional IRA assets to the custodian of her traditional IRA. The rollover will not include any amounts that are or were RMDs.

The PLR arrives at the following conclusions in approving Spouse's plan:

1. The Survivor's Trust retirement accounts are not inherited IRAs (or inherited Roth IRAs) with respect to Spouse for purposes of §408(d)(3).

Observation: Had they been classified as inherited IRAs, Spouse's rollover transactions would not have been permitted.

2. Spouse cannot elect to treat Decedent's IRAs as her own, because the Survivor's Trust was named as the beneficiary of each of the IRAs.

3. Spouse's planned rollovers are, however, OK. Because Spouse is the trustee and sole beneficiary of the Survivor's Trust and is entitled to the income and principal of the Survivor's Trust up to and including the entire trust estate of the Survivor's Trust, for purposes of applying §408(d)(3)(A) to Decedent's IRAs, Spouse is effectively the individual for whose benefit the accounts are maintained. As a result, if Spouse receives a distribution of the proceeds of Decedent's Roth IRAs and Decedent's traditional IRA, she may roll over the distribution (other than RMDs) into a Roth IRA and a traditional IRA established and maintained in her name. To get around the §408(d)(3)(B) one-rollover-per-year rule with respect to the Roth IRAs, the PLR suggests that Trust would need to consolidate the Roth IRAs into a single Roth IRA by way of a series of trustee-to-trustee transfers.

4. Beginning with the year following the year in which Spouse rolls over a Roth IRA distribution to her own Roth IRA, she will not be required to take RMDs from Spouse's Roth IRA as per §408A(c)(5).

5. Beginning with the year following the year in which Spouse rolls over a distribution from Decedent's traditional IRA to her own traditional IRA, RMDs from Spouse's traditional IRA will be determined by treating her as the IRA owner.

PLR 201706004.

Where an IRA owner died before receiving any IRA distributions, his IRA provided that a trust that he purportedly created was the IRA beneficiary, there was no evidence that he actually created the trust, and a state court approved a change in the beneficiary designation so that his widow was the beneficiary, the result was that the IRA was not an inherited IRA.

Under §408(d)(1), except as otherwise provided in §408(d), any amount paid or distributed out of an IRA must be included in gross income by the payee or distributee, as the case may be, in the manner provided under §72.

§408(d)(3) provides that §408(d)(1) does not apply to a rollover contribution.

In the case of an inherited IRA, §408(d)(3) does not apply to any amount received by an individual from such account, and such inherited account is not treated as an IRA for purposes of determining whether any other amount is a rollover contribution. (§408(d)(3)(C)(i)) An IRA is treated as inherited if the individual for whose benefit the account is maintained acquired such account by reason of the death of another individual, and such individual was not the surviving spouse of such other individual. (§408(d)(3)(C)(ii))

§408(d)(3)(E) provides that the rollover provisions of §408(d) do not apply to any amount required to be distributed under §408(a)(6).

§408(a)(6) and Regulation §1.408-8, Q&A 1 provide that an IRA is subject to the required minimum distribution rules under §401(a)(9). In order to satisfy §401(a)(9), the rules of Regulation §1.401(a)(9)-1 through Regulation §1.401(a)(9)-9 must be applied, except as otherwise provided.

In general, a trust will not be considered qualified unless the plan provides that the entire interest of each employee: (i) will be distributed to such employee not later than the required beginning date, or (ii) will be distributed, beginning not later than the required beginning date, over the life of such employee or over the lives of such employee and a designated beneficiary or over a period not extending beyond the life expectancy of such employee or the life expectancy of such employee and a designated beneficiary. (§401(a)(9)(A))

§401(a)(9)(B)(ii) provides that a trust does not constitute a qualified trust unless the plan provides that, if an employee dies before the distribution of the employee's interest has begun in accordance with §401(a)(9)(A)(ii), the entire interest of the employee will be distributed within five years after the death of such employee. In order to satisfy the 5-year rule in §401(a)(9)(B)(ii), the employee's entire interest must be distributed by the end of the calendar year which contains the fifth anniversary of the date of the employee's death. (Regulation §1.401(a)(9)-3, Q&A 2)

Under §401(a)(9)(E), for purposes of §401(a)(9), the term designated beneficiary means any individual designated as a beneficiary by the employee. Regulation §1.401(a)(9)-4, Q&A 4, provides, in relevant part, that in order to be a designated beneficiary, an individual must be a beneficiary as of the date of the employee's death.

Decedent maintained an IRA, IRA C, with Custodian A. Decedent, a resident of State D, died before receiving any distributions from the IRA. The beneficiary forms on file with Custodian A provided that the pay-on-death beneficiary for IRA C was an inter vivos trust created by Decedent. However, there was no evidence that Decedent created this trust. Custodian A did not keep a copy of the trust in its file when it accepted the Decedent's beneficiary designation. Taxpayer B looked through Decedent's records and was unable to find any evidence that a trust was created.

Decedent's will did not refer to any trust. Pursuant to Decedent's will, Decedent's entire estate was left to Taxpayer B. Taxpayer B, as the surviving spouse, wanted to roll over Decedent's IRA C to her own IRA.

The Probate Code of State D has a provision that allows a court to order a retroactive change in a beneficiary designation in certain limited circumstances. Taxpayer B intends to obtain court approval to change the beneficiary designation on IRA C from the trust to herself and then accomplish a rollover. However, because the beneficiary forms on file with Custodian A still listed a trust as beneficiary, Custodian A would not release the balance of IRA C to Taxpayer B unless she obtained a court order from state court to modify "the terms of a governing instrument in a manner that is not contrary to the transferor's probable intention in order to achieve a transferor's tax objectives."

IRS said that, following the entry of State D's court order approving the change of beneficiary designation on IRA C from the trust to Taxpayer B:

1. Taxpayer B is the individual for whose benefit the account is maintained. Taxpayer B acquired IRA C by reason of Decedent's death. Accordingly, Decedent's IRA C is not an inherited IRA for purposes of §408(d)(3) with respect to Taxpayer B.

2. The court order cannot create a "designated beneficiary" for purposes of §401(a)(9) because Taxpayer B was not the designated beneficiary of IRA C as of the date of Decedent's death. Accordingly, there is no "designated beneficiary" of IRA C for purposes of §401(a)(9).

3. Decedent died before the required beginning date and without a "designated beneficiary." Accordingly, the entire interest in IRA C must be distributed using the 5-year rule described in §401(a)(9)(B)(ii).

Under this rule, any amounts payable from IRA C to Taxpayer B in years 1 - 4 following the year in which Decedent died are not required minimum distributions and are eligible for rollover by Taxpayer B at a time that Taxpayer B is the beneficiary under IRA C, provided the distribution meets the other rollover requirements under §408(d). And, pursuant to §408(d), if rolled over, the amounts distributed from IRA C will not be included in Taxpayer B's gross income, with respect to the year in which the distribution occurs.

On or after January 1 of the fifth year following the year Decedent died, any amount payable from IRA C to Taxpayer B is not eligible for rollover because it is a required minimum distribution and will be included in Taxpayer B's gross income with respect to the year in which the distribution occurs.

PLR 201701023.

Public charity that, very soon after it was created and before it could attract significant other contributions, received a large grant from a foundation, could treat that grant as an "unusual grant." Unusual grants are excluded when applying the rule that publicly supported charities that receive more than 2% of their support from any one individual, corporation, etc. do not qualify as 50% charities.

Contributions by an individual to an organization that is a "50% charity" are deductible up to 50% of the donor's contribution base (§170(b)(1)(A)), which is the donor's adjusted gross income, computed without any net operating loss carryback deduction. (§170(b)(1)(G))

One type of 50% charity is a publicly supported organization. To qualify as a 50% charity, a publicly supported organization must normally receive a "substantial part" of its support (excluding amounts received from the performance of exempt functions) from either governmental bodies or from direct or indirect contributions from the general public. (§170(b)(1)(A)(vi))

In determining "substantial part" for purposes of the above rule, regulations have established a ⅓-of-support test (Regulation §1.170A-9(f)(2)) and a 10%/facts and circumstances test (Regulation §1.170A-9(f)(3)).

In determining whether the ⅓-of-support test or the 10%/facts and circumstances test is met, contributions by an individual, trust, or corporation are taken into account as "support" from the general public only to the extent the total amount of the contributions by any individual, etc. does not exceed 2% of the organization's total support during the applicable measuring period, except where the rule on the exclusion of "unusual grants" applies. (Regulation §1.170A-9(f)(6)(i))

That rule provides that, for purposes of applying the 2% limitation to determine whether the ⅓-of-support test is satisfied, one or more unusual grants may be excluded from both the numerator and the denominator of the applicable percent-of-support fraction.

The exclusion is generally intended to apply to substantial contributions or bequests from disinterested parties which: are attracted by reason of the publicly supported nature of the organization; are unusual or unexpected with respect to the amount thereof; and would, by reason of their size, adversely affect the status of the organization as normally being publicly supported. (Regulation §1.170A-9(f)(6)(ii))

Regulation §1.170A-9(f)(6)(iii) states that all pertinent facts and circumstances will be taken into consideration to determine whether a particular contribution may be excluded. No single factor will necessarily be determinative. This section references Regulation §1.509(a)-3(c)(4) which states that such factors may include:

1. Whether the contribution was made by a person who:

    a. Created the organization;
    b. Previously contributed a substantial part of its support or endowment;
    c. Stood in a position of authority with respect to the organization, such as a foundation manager within the meaning of §4946(b);
    d. Directly or indirectly exercised control over the organization; or
    e. Was in a relationship described in §4946(a)(1)(C) through §4946(a)(1)(G) with someone listed in items (a), (b), (c), or (d) above.

A contribution made by a person described in (a) through (e) is ordinarily given less favorable consideration than a contribution made by others not described above.

2. Whether the contribution was a bequest or an inter vivos transfer. A bequest will ordinarily be given more favorable consideration than an inter vivos transfer.

3. Whether the contribution was in the form of cash, readily marketable securities, or assets which further the exempt purposes of the organization, such as a gift of a painting to a museum.

4. Whether (except in the case of a new organization), prior to the receipt of the particular contribution, the organization (a) has carried on an actual program of public solicitation and exempt activities and (b) has been able to attract a significant amount of public support.

5. Whether the organization may reasonably be expected to attract a significant amount of public support after the particular contribution.

6. Whether the organization has a representative governing body as described in Regulation §1.509(a)-3(d)(3)(i).

7. Whether material restrictions or conditions within the meaning of Regulation §1.507-2(a)(7) have been imposed by the transferor upon the transferee in connection with the transfer.

Taxpayer is a public charity described in §509(a)(1) and §170(b)(1)(A)(vi). Taxpayer's mission is to enhance and support the work of law enforcement officers across the country through educational, direct assistance, and community outreach programs.

Taxpayer was recently formed and has only just begun to attract support from public sources in and out of Taxpayer's local community. Taxpayer has been actively engaged in seeking sources of funding in order to implement Taxpayer's charitable programs. Foundation B was informed about Taxpayer's mission through a mutual acquaintance and shares Taxpayer's interests in education and national security. As a result, Taxpayer was invited to apply for a grant from B. B has no prior affiliation with Taxpayer, did not create Taxpayer, and has no one in a position of authority within Taxpayer or on Taxpayer's Board of Directors.

Taxpayer subsequently submitted a grant application to B for a pilot program designed to measure and remedy local police perception through media, community involvement and training. Taxpayer was awarded the grant, which will be in cash, and which is to be used for community, education, and media outreach, police recognition awards, and scholarships to attend police academies. B has not imposed any conditions or restrictions on Taxpayer other than Taxpayer's application for and continued existence as a §501(c)(3) exempt public charity and the use of grant funds for the purposes set forth in Taxpayer's grant application. Any unused grant funds must be returned by a certain date unless Taxpayer requests an extension of time from B.

Taxpayer expects to attract significant and broad public support because Taxpayer's Board of Directors includes: two veteran law enforcement officers with extensive experience and networks of contacts in the law enforcement community; an experienced business executive with strong ties to business, religious, and political communities; and a founder/executive director of a separate public charity that combats global poverty. In addition, Taxpayer plans to establish a website to publicize Taxpayer's programs as well as accept contributions. Taxpayer also intends to apply for grants from government agencies, public charities, and private foundations. Furthermore, public outreach and educational initiatives will be a significant portion of Taxpayer's charitable activities.

None of Taxpayer's directors or officers is a trustee, director, agent, or employee of B, nor does B exert any control, direct or indirect, over Taxpayer.

Taxpayer has not previously applied for nor received any grants from B.

Due to its size, the grant will adversely affect Taxpayer's status as normally being publicly supported under §170(b)(1)(A)(vi) for the applicable period.

The grant qualifies as an unusual grant. IRS held that the grant from B is an unusual grant because the criteria set forth in Regulation §1.170A-9(f)(6)(ii) and Regulation §1.509(a)-3(c)(4) have been met.

The grant meets the requirements of Regulation §1.170A-9(f)(6)(ii) because it is from a disinterested party who was attracted by reason of the publicly supported nature of Taxpayer's organization, is unusual with respect to the amount thereof, and will, by reason of its size, adversely affect Taxpayer's status as normally being publicly supported.

The grant meets the requirements of Regulation §1.509(a)-3(c)(4) based on the following pertinent facts and circumstances:

1. The contribution was made by B, a disinterested party that:

    a. Did not create Taxpayer;
    b. Has not previously contributed to Taxpayer;
    c. Does not stand in a position of authority with respect to Taxpayer;
    d. Does not directly or indirectly exercise control over Taxpayer; and
    e. Was not in a relationship described in §4946(a)(1)(C) through §4946(a)(1)(G) with someone listed in items (a), (b), (c), or (d) above.

2. The contribution was in the form of cash, or equivalent, which furthers Taxpayer's exempt purposes.

3. Taxpayer is a new organization and has been actively engaged in seeking sources of public support and funding in order to implement Taxpayer's charitable programs.

4. Taxpayer reasonably expects to attract a significant amount of public support after the grant.

5. Taxpayer has a representative governing body as described in Regulation §1.509(a)-3(d)(3)(i)

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6. No material restrictions or conditions within the meaning of Regulation §1.507-2(a)(7) have been imposed by B.

PLR 201701002.

Foundation, that collected and analyzed data in order to improve community decision-making and thus improve the lives of low-income children and their families, could charge fees for certain data-based services without the fees being treated as unrelated business taxable income (UBTI). The services at issue both furthered the foundation's charitable purpose and were provided to exempt organizations that shared that purpose, and the fees were to be determined based on each such organization's ability to pay.

In general, exempt organizations are taxed on their "unrelated business income" i.e., income is derived from a trade or business, that is: (a) regularly carried on, and (b) not substantially related to the performance by the organization of its exempt purposes. (§511, §512, §513)

Under Regulation §1.513-1(d)(2), a trade or business is "related" to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income). Further, it is "substantially related," for purposes of §513, only if the causal relationship is a substantial one. For this relationship to exist, the production or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of exempt purposes. Whether this is so depends in each case upon the facts and circumstances involved.

In Revenue Ruling 72-369, 1972-2 CB 245, IRS held that an organization formed to provide managerial and consulting services at cost to unrelated §501(c)(3) organizations was itself not exempt under §501(c)(3). IRS reasoned that providing managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit, and the fact that the services were provided at cost and solely for exempt organizations was not sufficient to characterize the activity as charitable.

Similarly, in *B.S.W. Group, Inc.,* (1978) 70 TC 352, the Tax Court concluded that a corporation formed to provide consulting services to nonprofit organizations was not exempt under §501(c)(3) because its activities constituted the conduct of a trade or business that is ordinarily carried on by commercial ventures organized for profit. Its primary purpose was not charitable, educational, nor scientific, but rather commercial; and its only source of income was from fees which were set high enough to recoup all projected costs and produce a profit. And finally, the corporation had failed to limit its clientele to organizations that were §501(c)(3) exempt organizations.

§4943(a) imposes a tax equal to 10% of the value of any excess business holdings of a private foundation in a business enterprise. §4943(d)(3) provides that the term "business enterprise" does not include a "functionally related business," which in turn is defined in §4942(j)(4) as: (1) a trade or business which is not an unrelated trade or business (as defined in §513); or (2) an activity which is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which is related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exempt purposes of the organization.

Foundation is a tax-exempt organization described in §501(c)(3) and classified as a private operating foundation under §509(a) and §4942(j)(3). It was formed for the charitable purpose of improving the lives of low-income children and their families in State by, among other things, collecting, analyzing, interpreting, and sharing City metro region neighborhood data to improve community decision-making. It gets data from government agencies and school districts, allowing it to conduct in-depth analysis of community issues.

In addition to other activities, Foundation offers "technical assistance" (which it defines as requests that cannot be met through independent review of its website) to social sector organizations, including non-profits, foundations, government agencies, and community organizations that are similarly focused on improving the lives of low-income children and their families. Foundation represents that a client social sector organization seeks technical assistance because it does not have the in-house technical or subject-matter expertise to run the type of analysis it is requesting.

When determining whether to take on an organization's project, Foundation administers an extensive screening process to ensure that each project it agrees to undertake will advance its mission. Foundation represented that, except in the case where there are privacy restrictions on the data source, all of the data and information provided by the client for the project is added to Foundation's repository for use in other projects.

Foundation previously absorbed all costs of providing technical assistance. However, this severely limited the number of projects it could engage in, so Foundation proposes to charge a "reasonable fee" (fee) for technical assistance requests that require over four hours of staff time. The fee will reflect the clients' ability to pay and will generally be less than cost. Foundation will continue to perform certain other data activities without charge.

Foundation represents that, if it accepts a technical assistance request, the contract between Foundation and the client will provide that the client will not use the resulting product or information for any purpose other than the exempt purpose for which the Foundation agreed to provide the product or information, and will not resell the product or information.

The issues raised in the PLR were:

1. Whether the fees received for technical assistance will cause Foundation to be treated as being engaged in an unrelated trade or business under §513;

2. Whether the income derived from such fees will be subject to unrelated business income tax under §511;

3. Whether the services constitute a "business enterprise" under §4943(d)(3); and

4. Whether Foundation's provision of these services will subject it to excise taxes on excess business holdings under §4943.

IRS ruled that Foundation's technical assistance services are substantially related to its exempt purpose and thus will not be subject to unrelated business income tax under §511 or excess business holdings tax under §4943(a).

IRS found that the services provided were part of Foundation's exempt data activities and that Foundation's screening process ensures that it only undertakes projects that will serve its charitable mission of improving the lives of low-income children and their families. The PLR distinguished Foundation from the organizations in B.S.W. Group, Inc. and Revenue Ruling 72-369 because its technical assistance services both have a primarily charitable purpose and further the charitable purposes of Foundation as well as the client organizations. In addition, Foundation's access to raw data and the expertise of its employees distinguishes its services from those that are commercially available, and the fees that it will charge will be determined on a case-by-case basis (as opposed to at cost). Accordingly, the services will not constitute an unrelated trade or business, and income from them will not be subject to unrelated business income tax.

IRS further concluded that Foundation's technical assistance services constitute a "functionally related business" because they are a trade or business which is not an unrelated trade or business under §513. Accordingly, the services are not a "business enterprise" under §4943(d)(3), and fees from Foundation's provision of such services will not be subject to tax under §4943(a).

PLR 201647014.

IRS waived the 60-day rollover rule for the first of two IRA distributions made by a disabled taxpayer who mistakenly deposited the payouts in a non-IRA account. Thus, the amount of the first distribution could be deposited late into an IRA. However, the amount of the second distribution got no reprieve since §408(d)(3)(B) provides a one-IRA-rollover-per-year rule that cannot be waived.

There is no immediate tax if distributions from an IRA are rolled over to an IRA or other eligible retirement plan (i.e., qualified trust, governmental §457 plan, §403(a) annuity and §403(b) tax-shelter annuity). For the rollover to be tax-free, the amount distributed from the IRA generally must be recontributed to the IRA or other eligible retirement plan no later than 60 days after the date that the taxpayer received the withdrawal from the IRA. (§408(d)(3)) A distribution rolled over after the 60-day period generally will be taxed (and also may be subject to a 10% premature withdrawal penalty tax). (§72(t)) Only one tax-free IRA-to-IRA rollover per IRA account can be made within a one-year period. (§408(d)(3)(B))

IRS may waive the 60-day rule if an individual suffers a casualty, disaster, or other event beyond his reasonable control, and not waiving the 60-day rule would be against equity or good conscience (i.e., hardship waiver). (§408(d)(3)(I))

Observation: The Code does not provide for a hardship waiver of the §408(d)(3)(B) one-IRA-rollover-per-year rule.

Revenue Procedure 2003-16, 2003-1 CB 359, establishes a letter-ruling procedure for taxpayers to apply for a waiver of the 60-day rollover requirement and sets out several factors that IRS considers in determining whether to waive the 60-day rollover requirement. These factors include time elapsed since the distribution and inability to complete the rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country, postal error, errors committed by a financial institution, etc.

On March 10, 2015, a taxpayer we'll call Mr. Smith took a distribution from IRA B and, on March 12, 2015, deposited the amount of the distribution into a non-IRA savings account which was maintained by Financial Institution E. On March 30, 2015, Smith took another distribution from IRA B, which he also deposited into a non-IRA account with Financial Institution E. Both distributions have not been used for any other purpose.

Due to memory loss and confusion, Smith says he did not understand the implications of taking the two withdrawals from IRA B and depositing them into a non-IRA account. Smith had medical documentation that his symptoms of cognitive impairment began in 2010 and became more prominent beginning in January of 2015.

Via PLR request, Smith asked IRS to waive the 60-day rollover requirement for the two distributions from IRA B.

Observation: Effective August 24, 2016, taxpayers no longer have to submit PLR requests for waiver of the 60-day rollover deadline. Under Revenue Procedure 2016-47, 2016-37 IRB, there's a new self-certification procedure designed to help recipients of retirement plan distributions who, due to one or more specified reasons, inadvertently miss the 60-day time limit for properly rolling these amounts into another retirement plan or individual retirement arrangement (IRA).

IRS said that the information and documentation submitted were consistent with Smith's claim that his failure to accomplish a rollover of the first distribution within the 60-day period prescribed by §408(d)(3)(A) was due to cognitive impairment. Thus, pursuant to §408(d)(3)(I), IRS waived the 60-day rollover requirement for the first distribution from IRA B. Provided all other requirements of §408(d)(3), except the 60-day requirement, will be met for the contribution of the first distribution amount to an IRA, IRS said that the contribution will be treated as a rollover contribution within the meaning of §408(d)(3).

However, IRS could not help with the second distribution from Smith's IRA, because §408(d)(3)(B) imposes a 1-year limitation on IRA-to-IRA rollovers. Thus, IRS ruled that the second distribution amount cannot be rolled over into an IRA.

PLR 201646007.

IRS has revoked a volunteer fire department's self-declared exempt status as a labor, agricultural or horticultural organization under §501(c)(5). However, IRS also concluded that the organization could be exempt either as a §501(c)(4) social welfare organization or a §501(c)(3) charitable organization.

Under §501(c)(5), labor, agricultural and horticultural organizations are exempt from income tax if no net income inures to the benefit of any member and their objectives are the betterment of conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of higher efficiency.

Under §501(c)(4), civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare are exempt from income taxation if no part of their earnings inures to the benefit of any private shareholder or individual and no substantial part of the organization's activities consists of providing commercial-type insurance. In Revenue Ruling 74-361, 1974-2 CB 159, IRS provided, in part, that because the activities of the organization (providing fire and rescue services for the general community) could also be regarded as promoting the common good and general welfare of the community, the organization could have applied for and received a ruling recognizing its exemption from Federal income tax as a social welfare organization under §501(c)(4).

§501(c)(3) provides for the exemption from federal income tax of organizations that are organized and operated exclusively for specified purposes, such as religious, charitable, scientific, or educational purposes. An organization must be both organized and operated exclusively for one or more of the specified purposes. (Regulation §1.501(c)(3)-1(a)(1)) Cases have held that providing fire and rescue service for the general community is a charitable purpose because it lessens the burden of government. (*McKenna,* (1945) 5 TC 712, acq., 1950-2 CB 3) Further, IRS in Revenue Ruling 69-174, 1969-1 CB 149, held that rescue service for the relief of distressed persons was also a charitable purpose. In Revenue Ruling 71-47, 1971-1 CB 92, IRS held that contributions or gifts to nonprofit volunteer fire companies, which were for the use of a political subdivision of a State for exclusively public purposes, were deductible under §170(c)(1).

Nonprofit Organization, which has been in existence since the 1800s, was organized and operated as an all-volunteer fire department. It provided fire protection, ambulance and rescue services to the community. District provided it with a fleet of fully equipped emergency vehicles which were housed in a building that Organization owned.

In examining Organization, IRS determined that on its Form 990 (Return of Organization Exempt From Income Tax), it incorrectly self-declared its exempt status under §501(c)(5).

In the PLR, IRS concluded that Organization was not operated as a labor, agricultural or horticultural organization under §501(c)(5). IRS determined that its self-declared exempt §501(c)(5) status should be revoked because it did not have its objectives in the betterment of the conditions of those engaged in labor, agricultural or horticultural pursuits, the improvement of the grade of their products, or the development of a higher degree of efficiency in their respective occupations.

IRS further found that, after the revocation of Organization's self-declared §501(c)(5) status, it could self-declare under §501(c)(4) by filing Form 990 and indicating that exempt status. Or Organization's activities could also be considered charitable within the meaning of §501(c)(3) and Revenue Ruling 69-174. However, if Organization chooses to pursue an exemption under §501(c)(3), it could not self-declare its exemption but would have to a file Form 1023 (Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code) with IRS.

PLR 201645017.

An organization which formed a coffee shop "where believers could interact with non-believers in a safe and friendly environment to convey the Gospel in a non-confrontational manner" did not qualify for an exemption from federal income tax under §501(c)(3).

§501(c)(3) provides for the exemption from federal income tax of organizations that are organized and operated exclusively for specified purposes, such as religious, charitable, scientific, or educational purposes. (Regulation §1.501(c)(3)-1(a)(1)) To be recognized as exempt, an organization must be both organized and operated exclusively for one or more of the specified purposes. (Regulation §1.501(c)(3)-1(a)(1)) An organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of the exempt purposes. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. (Regulation §1.501(c)(3)-1(c)(1))

In Revenue Ruling 68-72, 1968-1 CB 250, IRS found that a nonprofit organization that operated a supervised facility (a "coffee house") to bring together young people of college age with church leaders, educators, and leaders to discuss religion, current events, and social problems, could be exempt under §501(c)(3). There was a nominal charge for admission but no charges for refreshments and entertainment. The organization met it expenses from contributions and the admission charges.

In Revenue Ruling 73-127, 1973-1 CB 221, IRS held that an organization that operated a cut-price retail grocery outlet and allocated a small portion of its earnings to provide on-the-job training to the hard-core unemployed did not qualify for exemption. While the purpose of providing such job training was charitable and educational, the purpose of operating a retail grocery store was not. The operation of the store and the training program were two distinct purposes. Since the former was not a recognized charitable purpose, the organization was not organized and operated exclusively for charitable purposes.

In Revenue Ruling 76-94, 1976-1 CB 171, an organization that provided a resident facility and therapeutic program for emotionally disturbed adolescents, operated a grocery store as part of its therapy program. The store was supervised by a manager who was experienced in both the retail food industry and in working with disturbed adolescents. IRS held that since the grocery store was almost fully staffed by the adolescent residents and was operated at a scale no larger than was reasonably necessary for the organization's training and rehabilitation program, the operation of the store was not a related trade or business.

In *Better Business Bureau of Washington, D.C., Inc. v. U.S.* (S Ct 1945) 34 AFTR 5, the Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy a claim for exemption regardless of the number or importance of truly exempt purposes.

In *B.S.W. Group, Inc.,* (1978) 70 TC 352, the Tax Court held that an organization did not qualify for exemption under §501(c)(3) because it was primarily engaged in an activity that was characteristic of a trade or business and was ordinarily carried on by for-profit commercial businesses. Similarly, in *Living Faith, Inc.,* (CA 7 1991) 69 AFTR 2d 92-301, the Seventh Circuit affirmed that the organization did not qualify for exemption because it operated its restaurants and health food stores for a substantially commercial purpose. Its underlying religious purposes did not mitigate the clear commercial purpose of its operations.

Organization opened a coffee shop that sold coffee locally and planned to eventually sell it online as well. The coffee shop existed to: (1) give away 100% of profits to community based non-profit organizations and individuals; (2) provide a safe, inviting, and informal gathering place; (3) serve coffee and light fare for a price; and (4) help revitalize the downtown area. Under one of its programs (Program), a donor could pay for a certain amount of coffee in advance, so that when customers came in they were told that their coffee, while not "free," had already been paid for-"just like Jesus already paid the price for all of our sins by dying on the cross for us." Organization also gave away meals and drinks to the homeless and helped connect them with local ministries for lodging and jobs.

The coffee shop was located in the downtown area where there was no other similar business and so satisfied an unmet need for a gathering space that was open late and offered the community a safe place to gather. The coffee shop, which was open six days a week, provided a location for both formal and informal Bible study, church group meetings, and meetings for other organizations. Its location had been used for a women's Bible study, a men's Bible ministry, meetings of church elders, book signings, birthday parties, baby and bridal showers, community business meetings, game nights, live music, and similar events. Organization did not typically charge a fee for the use of space by groups or organizations but advised users that a donation was welcome; access or use of the room had never been denied due to an inability to pay or a decision not to donate.

Organization also partnered with other ministries, missionaries, and non-profit organizations by regularly highlighting their activities to help raise funds, supplies, and recognition for them. Organization also participated in other community activities, including a training program that helped train underserved youth by placing them in a local business for a 6-week internship and a prison ministry that connected Organization and its customers to children with incarcerated parents.

Almost all of Organization's revenue came from the sale of food items. Its largest expense was for salaries and wages. Other expenses included occupancy expenses and expenses for cost of goods sold, advertising, licenses and permits, insurance, supplies, and repairs and maintenance. Organization had not yet earned profits that would allow it to give away any substantial amount of money but it hoped to be able to do so in the near future.

IRS concluded that Organization was not operated exclusively for §501(c)(3) purposes because a substantial portion of its activities consisted of the operation of a coffee shop in a commercial manner.

IRS found that Organization was distinguishable from the organization in Revenue Ruling 68-72 - where church leaders, educators, and leading businessmen of the community discussed religion, current events, and social problems in a "coffee house"-because the majority of Organization's activities entailed the operation of its coffee shop in a commercial manner. Organization did not conduct any regular religious or educational activities at its facility. Such activities (e.g., Bible studies) were conducted by groups that used Organization's space. Further, Organization allowed its space to be used by the public for all activities (e.g., business meetings, birthday parties, and baby and bridal showers), not just those that were religious, charitable, or educational. Unlike in Revenue Ruling 68-72, where no fee was charged for refreshments, Organization charged for the food and beverages, and the majority of Organization's expenses were met by funds from these sales.

Similarly, Organization was similar to the organization with the grocery store described in Revenue Ruling 73-127 because the operation of the coffee shop and its programs to further the Gospel of Jesus Christ, partner with other organizations, and participate in community activities were separate and distinct activities. Since the operation of the coffee shop was a substantial part of its activities and was not a recognized charitable purpose, it was not organized and operated exclusively for §501(c)(3) purposes. And, unlike the grocery store in Revenue Ruling 76-94, Organization's operation of its coffee shop was its main function; its religious and charitable programs were secondary to its overall coffee shop activities.

As in *B.S.W. Group, Inc. and Living Faith, Inc.*, Organization had a significant non-exempt commercial purpose: a coffee shop that was open to the public six days a week in competition with other commercial markets. IRS found that this was indicative of a business. Organization's primary sources of revenues were from coffee shop sales and its expenses were mainly for salaries, cost of goods sold, and other items needed to support the operation of the coffee shop. Taking in totality, Organization's operation of the coffee shop constituted a significant non-exempt commercial activity.

Similar to the organization in B.S.W. Group, Inc., the coffee shop's primary purpose was commercial. IRS noted that Organization chose its location because there was no other similar business downtown and it charged fees for its food and beverages and planned to eventually sell its coffee beans online.

IRS also noted that, while donating funds to other non-profit community organizations was a charitable under purpose Regulation §1.501(c)(3)-1(d)(2), Organization's main focus was the operation of a coffee shop. And, while some of the activities that took place in the coffee shop, such as Program, aimed to advance religion, more than an insubstantial portion of Organization's activities served a commercial purpose. Under Regulation §1.501(c)(3)-1(c)(1), Organization was not "operated exclusively" for one or more exempt purposes because it did not engage primarily in activities which accomplished one or more of the §501(c)(3) exempt purposes.

Legal Advice Issued by Field Attorneys 20172801F.

Under §6501(c)(3), the period of limitations on assessing gift tax remained open for the years that the donor failed to file any Forms 709, United States Gift (and Generation-Skipping Transfer) Tax Return. IRS also found that, for another year, the period of limitations remained open under §6501(c)(9) because the Form 709 that was filed neither described the transferred property nor provided a description of the method used to determine its value.

The Code imposes a tax on a transfer of property by gift. (§2501(a)) In general, any individual who makes a transfer by gift in any calendar year must file a gift tax return for that year using Form 709. (§6019, Regulation §25.6019-1(a))

Absent an exception, IRS must assess the amount of any gift tax within three years after Form 709 is filed. (§6501(a)) An exception applies to the tax on a gift not adequately disclosed on a gift tax return on which it was required to be reported. (§6501(c)(9))

If no return was filed, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time. (§6501(c)(3))

If a transfer of property is not adequately disclosed on a gift tax return, or in a statement attached to the return, filed for the calendar period in which the transfer occurs, then any gift tax on the transfer may be assessed, or a proceeding in court for the collection of the appropriate tax, may begin without assessment at any time. (Regulation §301.6501(c)-1(f)(1))

A gift is not adequately disclosed unless it is "reported in a manner adequate to apprise [IRS] of the nature of the gift and the basis for the value so reported." (Regulation §301.6501(c)-1(f)(2)) A transfer will be considered adequately disclosed to IRS if the following information is provided:

1. A description of the transferred property and any consideration received by the transferor;

2. The identity of, and relationship between, the transferor and each transferee;

3. If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the complete trust instrument;

4. A detailed description of the method used to determine the fair market value of the property transferred, including any financial data (for example, balance sheets, etc. with explanations of any adjustments) that were utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value of the property, and a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property. (Alternately, a donor can provide an appraisal in lieu of this information, see Regulation §301.6501(c)-1(f)(3)); and

5. A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer. (Regulation §301.6501(c)-1(f)(2))

To start the running of the limitations period on assessment where the gift was not reported on the return or the required information about the gift was not submitted, the donor must file an amended gift tax return for the calendar year in which the gift was made. The amended return must identify the transfer and provide all of the information required by Regulation §301.6501(c)-1(f)(2) that was not previously submitted with the original return. The limitations period will start to run when the amended return is filed. (Revenue Procedure 2000-34, 200-2 CB 186)

Donor made gifts in Years 1, 2, 3, 4, 5, and 6, but did not file Forms 709 for those years. Donor also made gifts in Year 7, and filed a Form 709 for that year. On the Year 7 Form 709, Donor did not describe any of the property transferred in Year 7, nor did Donor provide a description of the method used to determine the value of that property.

In the LAFA, IRS concluded Donor did not file Forms 709 and did not otherwise report the gifts made in Years 1 through 6. Accordingly, under §6501(c)(3), the period of limitations on assessing tax on these gifts did not expire.

While Donor filed a Form 709 to report the Year 7 gifts, Donor failed to adequately report any of the Year 7 gifts because Donor did not describe the transferred property or provide a description of the method used to determine the value of the transferred property. Accordingly, under §6501(c)(9), the period of limitations on assessing tax on the Year 7 gifts did not expire.

In the LAFA, IRS also noted that under Revenue Procedure 2000-34, Donor may begin the running of the statute of limitations by filing complete and accurate Forms 709 for Years 1-7.

Legal Advice 2017-001.

Associate Chief Counsel for Tax Exempt & Government Entities has advised that IRS should not enter into voluntary closing agreements with employers who did not timely take into account nonqualified deferred compensation (NQDC) for FICA purposes and now seek to resolve tax years that are barred from assessment. As a policy matter, it was not appropriate to enter into a closing agreement where regulations provide for the correction of NQDC reporting failures.

Both the employee and employer are liable for taxes under the Federal Insurance Contributions Act (FICA), which consist of the old-age, survivor, and disability insurance (OASDI or social security) tax and the hospital insurance (HI or Medicare) tax. Compensation for employment paid during a calendar year in excess of the social security wage base ($127,200 for 2017) is excluded from taxable FICA wages. There is no wage base for the Medicare tax. The Additional Medicare Tax is a 0.9% tax on taxpayers (other than corporations, estates, or trusts) receiving wages with respect to employment in excess of $200,000 ($250,000 for married couples filing jointly and $125,000 for married couples filing separately). (§3101(b)(2))

Wages usually are subject to FICA tax when actually or constructively paid ("the general timing rule"). Under the "special timing rule" for NQDC, an amount deferred under a NQDC plan is taken into account (i.e., treated as wages) for FICA purposes on the later of: (a) the date on which the services creating the right to that amount are performed; or (b) the date on which the right to the deferred amount is no longer subject to a substantial risk of forfeiture. (§3121(v)(2), Regulation §31.3121(v)(2)-1(a)(2))

Under the nonduplication rule, once an amount deferred under a NQDC plan is taken into account as wages under the special timing rule, neither that amount nor any income attributable to that amount is again treated as FICA wages. (§3121(v)(2)(B), Regulation §31.3121(v)(2)-1(a)(2)(iii))

If an amount that has been deferred under a NQDC plan for a period is not taken into account in computing FICA taxes, then the nonduplication rule does not apply, and benefit payments attributable to that deferred amount are included as wages under the general timing rule (Regulation §31.3121(v)(2)-1(d)(1)(ii)(A)) For example, if an amount deferred is required to be taken into account in a particular year, but the employer fails to pay the additional FICA tax attributable to that amount, then the amount deferred and the income attributable to that amount must be included as wages for FICA tax purposes when actually or constructively paid.

If an employer fails to pay FICA tax on amounts deferred as required under §3121(v)(2), it is required to adjust its employment tax returns for any years for which the period of limitations has not expired, to report and pay the additional FICA tax attributable to the amounts deferred and required to be included under the special timing rule. If the employer does so, the nonduplication rule will apply to the payment of the deferred compensation. However, the general timing rule will apply to any amounts deferred and income attributable to those amounts deferred for closed years that cannot be adjusted.

A transition rule allowed employers relief for amounts deferred and benefits paid before January 1, 2000. This rule effectively allowed employers a limited opportunity to correct closed periods for noncompliance with the special timing rule by making adjustments in subsequent years and obtain the benefits of the nonduplication rule. (Regulation §31.3121(v)(2)-1(g)(4)(ii))

The special timing rule generally accelerates the FICA tax timing of NQDC to the time of deferral so no FICA tax is due on amounts deferred or income attributable to the amounts deferred when they are paid to the employee. This generally results in less total FICA tax being paid than if the FICA taxes were paid at the time the benefits are distributed.

The social security portion of FICA tax is only imposed on wages up to the social security wage base. FICA tax paid in the year of deferral may only consist of the Medicare tax (and possibly the Additional Medicare tax) on the amounts deferred because the employee may have other wages equal to or greater than the social security wage base for that year. Also, less FICA tax is imposed because earnings on the amounts deferred are not subject to FICA tax under the nonduplication rule.

On the other hand, paying FICA tax at the time of distribution rather than at the time of deferral, generally results in more total FICA tax being paid. The social security portion of FICA tax is only imposed on wages up to the social security wage base. At the time of distribution, employees are often retired and therefore less likely to have other wages equal to or greater than the social security wage base for that year. Also, more FICA tax is imposed because earnings on the amounts deferred are also subject to FICA tax (although the FICA tax on earnings is paid in later years than the time of deferral and accrual of earnings).

Under §7121(a), IRS may enter into a written agreement with any taxpayer relating to his liability for any internal revenue tax. Regulation §301.7121-1(a) provides that a closing agreement may be entered into in any case in which there appears to be an advantage in having the case permanently and conclusively closed, or if good and sufficient reasons are shown by the taxpayer for desiring a closing agreement and it is determined by IRS that the U.S. will sustain no disadvantage through consummation of such an agreement.

Closing agreements sought to remedy NQDC problem. Employers have submitted requests to enter into voluntary closing agreements regarding NQDC plans. These requests have been submitted by employers who have discovered, after the applicable statute of limitations has expired, that they did not comply with the special timing rule. These employers have asked to enter into closing agreements to resolve the taxation of NQDC for statutorily barred tax years and indicate that they are willing to both waive the right to argue that the assessment of such tax is statutorily barred, as well as agree to comply with the special timing rule prospectively.

The closing agreement would, if granted, permit the employers to pay FICA tax in a subsequent year that is prior to the year of payment in order to reduce the amount of total FICA taxes that would otherwise be due under the general timing rule if FICA tax was applied at the time the wages were paid. The employer may also want to avoid application of an allocation rule in the regulations that imposes FICA tax on a portion of each payment if the employer took part (but not all) of the NQDC into account for FICA tax under the special timing rule.

IRS's Associate Chief Counsel for Tax Exempt & Government Entities has advised that, as a policy matter, a closing agreement should not be entered into if it would have the effect of avoiding application of the regulatory mechanism for the payment of FICA taxes where NQDC was not timely taken into account under the special timing rule. The existence of the special transition rule in the regulations for years for which the period of limitations had expired at the time the regulations were finalized reinforces the importance of adhering to the rules in Regulation §31.3121(v)(2)-1(d)(1)(ii) for determining the FICA tax due upon payment of amounts that were deferred in prior years and that should have been taken into account in such prior years but for which the period of limitations has since expired.

Program Manager Technical Advice 2017-002.

In a Program Manager Technical Advice (PMTA), IRS has found that, in three scenarios, the §5891 40% tax on certain purchases of structured settlement payment rights applied.

§5891(a) imposes, on any person who acquires directly or indirectly structured settlement payment rights in a structured settlement factoring transaction, a tax equal to 40% of the factoring discount with respect to such factoring transaction.

However, §5891(b)(1) provides that the tax imposed under §5891(a) does not apply to a structured settlement factoring transaction if the transfer of structured settlement payment rights is approved in advance in a qualified order.

Under §5891(b)(2), the term "qualified order" means a final order, judgment, or decree that (A) finds that the transfer of structured settlement payment rights does not contravene any Federal or state statute, or the order of any court or responsible administrative authority, and is in the best interest of the payee; and (B) is issued (i) under the authority of an applicable State statute by an applicable State court, or (ii) by the responsible administrative authority (if any) which has exclusive jurisdiction over the underlying action or proceeding which was resolved by means of the structured settlement.

§5891(b)(3) provides that the term "applicable State statute" means a statute providing for the entry of an order, judgment, or decree described in §5891(b)(2)(A) that is (A) enacted by the State in which the payee of the structured settlement is domiciled, or (B) if there is no such statute, a statute that is enacted by the State in which either the party to the structured settlement (including an assignee under a qualified assignment under §130) or the person issuing the funding asset for the structured settlement is domiciled or has its principal place of business.

§5891(b)(4)(A) provides that the term "applicable State court" means, with respect to any applicable state statute, a court of the State that enacted such statute. Under §5891(b)(4)(B), if the payee of the structured settlement is not domiciled in the State that enacted the statute, the term also includes a court of the State in which the payee is domiciled.

Structured settlements are settlements of tort claims involving physical injuries or physical sickness, and workers' compensation claims, under which settlement proceeds take the form of periodic payments, including scheduled lump sum payments. The full amount of each periodic payment, including the amount attributable to earnings under the annuity contract, is excludable from the settlement recipient's income under §104(a)(1) or §104(a)(2). The payments must be of a character described in §130(c)(2)(A) and §130(c)(2)(B). (§5891(c)(1))

§5891(c)(2) defines the term "structured settlement payment rights" to mean rights to receive payments under a structured settlement.

With exceptions, a "structured settlement factoring transaction" is a transfer of structured settlement payment rights made for consideration by means of sale, assignment, etc. (§5891(c)(3))

Under §5891(c)(4), the term "factoring discount" is defined as an amount equal to the excess of: (A) the aggregate undiscounted amount of structured settlement payments being acquired in the structured settlement factoring transaction; over (B) the total amount actually paid by the acquirer to the person from whom such structured settlement payments are acquired.

The PMTA sets out three scenarios.

a. Scenario 1: Payee, an individual, is domiciled in State A. Payee receives a stream of payments from a structured settlement, as defined in §5891(c)(1). After several years of receiving the payments under the structured settlement, Payee decides to sell the future payment rights to Factor, a factoring company. Factor and Payee enter into an agreement pursuant to which Factor will acquire Payee's structured settlement payment rights in exchange for a lump sum. State A has a Structured Settlement Protection Act (SSPA), which requires that transfers of structured settlement payment rights must receive advance court approval in order to be valid. The SSPA meets the requirements for an "applicable state statute" within the meaning of §5891(b)(3).

Factor does not file a petition to acquire Payee's payment rights in a court in State A, but files the petition in State B. In its petition, Factor represents that Payee is domiciled in State B, despite Payee having been domiciled in State A when the petition was filed, and at all times during the approval process.

In addition, Factor represents to the court that the transfer meets all the conditions found in §5891(b)(2)(A)(i) and §5891(b)(2)(A)(ii). The State B court approves the transfer of Payee's structured settlement payment rights to Factor, and orders the person funding the structured settlement to redirect the payments to Factor, as transferee. Factor begins to receive payments pursuant to the State B court's order.

b. Scenario 2: The facts are the same as the facts in Scenario 1, except that subsequent to the order issued by the court in State B, IRS initiates an examination of Factor's company records to determine any tax liability under §5891. IRS proposes asserting the tax on the transaction described in Scenario 1, arguing that the structured settlement factoring transaction does not meet the exception to the tax in §5891(b) because Factor did not obtain a "qualified order" under §5891(b)(2). In an attempt to remedy the situation, Factor files a petition in a court in State A to approve the transfer pursuant to the original State B court order. The court in State A approves the original transfer. Factor provides the State A court's order to IRS and argues that the transfer has been approved in a "qualified order" and thus no tax is due.

c. Scenario 3: The facts are the same as in Scenario 1, except that Payee decides to sell the future payment rights to Parent, a factoring company. In addition, in its petition to the court in State B, Parent requests that the court approve and order the assignment of the payments to Subsidiary, which is wholly-owned by Parent and finances Parent's factoring transactions. The State B court approves the transfer, and per the request of Parent, orders the person funding the structured settlement to redirect the payments to Subsidiary. Subsidiary begins to receive payments under the structured settlement pursuant to the State B court order.

The tax applies in all three scenarios. The §5891 tax applies in all three of the scenarios.

In Scenario 1, Payee is domiciled in State A, and State A has an SSPA, which is an "applicable state statute" within the meaning of §5891(b)(3). Therefore, in order to qualify for the exception in §5891(b), Factor must obtain a "qualified order" that complies with §5891(b)(2) from State A, an applicable state court within the meaning of §5891(b)(4), approving in advance the transfer of Payee's payment rights to Factor. Factor did not obtain an order from a court in State A pursuant to State A's SSPA as required by §5891(b)(2) and §5891(b)(3). Instead, Payee obtained an order from a court in State B by misrepresenting to the court the domicile of Payee. The State B court is not an applicable state court under §5891(b)(4)(A). Accordingly, the order from the court in State B is not a "qualified order" that complies with the requirements of §5891(b)(2). Consequently, the §5891(a) tax applies to Factor.

The facts in Scenario 2 are the same as in Scenario 1, except that subsequent to the initiation of an examination of Factor by IRS, Factor petitioned the court in State A to approve the original order issued by the court in State B in an attempt to remedy the situation. Although Factor ultimately received an order approving the transfer of Payee's structured settlement payment rights from a court in State A, the order was obtained after the transfer of the structured settlement payment rights to Factor from Payee pursuant to the order of the State B court. §5891(b)(1) states that the tax imposed under §5891(a) does not apply to a structured settlement factoring transaction in which the "transfer of structured settlement payment rights is approved in advance in a qualified order." In Scenario 2, the order of the court in State A approved the transfer of Payee's structured settlement payment rights after the transfer of such rights to Factor pursuant to the order issued by the State B court. Consequently, the requirements of §5891(b)(1) have not been met in Scenario 2, and the tax applies to Factor.

Scenario 3 is the same as Scenario 1, except that the court in State B approves the transfer of Payee's structured settlement payment rights, and per the request of Parent, orders the person funding the structured settlement to redirect the payments to Subsidiary, Parent's assignee. As in Scenario 1, Payee did not obtain a "qualified order" within the meaning of §5891(b)(2). Therefore, a tax applies to Parent.

In addition, there is support in the "directly or indirectly" language in §5891(a) for asserting the tax against Subsidiary if it is found upon examination that Subsidiary acquired (indirectly) Payee's structured settlement payment rights. For example, the tax may be asserted against Subsidiary if Parent is a shell company or straw man or if the substance of the transaction is that Subsidiary indirectly acquired the structured settlement payment rights.

Information Letter 2017-0018.

IRA distribution from a failed financial institution that was actually made by the Federal Deposit Insurance Corporation (FDIC) as receiver was not subject to the one-rollover-per-year limit on nontaxable IRA rollovers.

§408(d)(3)(A)(i) provides generally that any amount distributed from an IRA will not be included in the gross income of the distributee to the extent the amount is paid into an IRA for the benefit of the distributee no later than 60 days after the distributee receives the distribution (a "60-day rollover").

§408(d)(3)(B) provides that an individual is permitted to make only one nontaxable 60-day rollover between IRAs in any 1-year period.

At one time, IRS's position was that the one-rollover-per-year limit was applied on an IRA-by-IRA basis. But IRS changed its position following the Tax Court's holding in Bobrow, TC Memo 2014-21 that the one-year limit applies on an aggregate basis meaning that an individual cannot make more than one nontaxable 60-day rollover within each 1-year period even if the rollovers involved different IRAs.

Under the current rules, there's no current tax if the distribution is rolled over to another IRA, as long as the rollover is made within 60 days and the depositor did not roll over another IRA distribution that had been received in the preceding 12 months.

The one-rollover-per-year limit does not apply to rollovers to or from other types of retirement plans, nor does it apply to rollovers from a traditional IRA to a Roth IRA.

One of the directors of the FDIC asked IRS how the one-rollover-per-year limit applies to an IRA distribution made from a failed financial institution for which the FDIC has been appointed receiver and for which there is no acquirer for the IRAs maintained with the failed institution.

In the IL, IRS responds that an IRA distribution made from a failed financial institution by the FDIC as receiver is disregarded for purposes of applying the one-rollover-per-year limit, as long as:

1. Neither the failed financial institution nor the depositor initiated the distribution, and

2. No financial institution has assumed the IRAs of the failed financial institution.

The IL points out that this issue has come up before. In a 1991 Chief Counsel letter, IRS said that the legislative history indicated that the purpose of the restriction on multiple rollovers was to prevent abuse by way of voluntary transfers. Congress did not seek to limit through the 12-month restriction a situation where neither the custodial institution nor the depositor initiates, nor can prevent, the IRA distribution.

Information Letter 2016-0082.

Effect of retroactive Medicare coverage on a taxpayer's eligibility to contribute to a health savings account (HSA) and advised the taxpayer on how to avoid the §4973 excise tax on contributions that, by virtue of the retroactive coverage, exceeded the maximum annual contribution amount.

Eligible individuals may, subject to statutory limits, make deductible contributions to an HSA. (§223) An HSA is a trust created or organized in the U.S. as a health savings account exclusively for the purpose of paying the qualified medical expenses of the account beneficiary and that satisfies other delineated requirements. (§223(d)) Distributions from an HSA for "qualified medical expenses" of the account beneficiary, his spouse, or his dependents are generally excluded from the account beneficiary's income. (§223(f)(1))

An "eligible individual" is someone covered under a high deductible health plan (HDHP), who is not covered under any other health plan that is not a high deductible plan, unless the other coverage is permitted insurance (e.g., for worker's compensation, a specified disease or illness, or insurance providing a fixed payment for hospitalization). (§223(c)) An eligible individual may contribute 1/12 of the maximum permissible annual contribution amount to an HSA for each month that he is eligible. For 2017, the maximum annual contribution to an HSA is $3,400 for self-only coverage and $6,750 for family coverage. In addition, an annual $1,000 catch-up contribution is permitted for individuals age 55 or over. Contributions in excess of this amount may give rise to a 6% excise tax under §4973.

Under §223(b)(7), an individual ceases to be an eligible individual starting with the month he is entitled to benefits under Medicare. Under this provision, however, mere eligibility for Medicare does not disqualify an individual from contributing to an HSA. Instead, the term "entitled to benefits under" Medicare means both eligibility and enrollment in Medicare. Therefore, an otherwise eligible individual who is not actually enrolled in Medicare Part A or Part B may contribute to an HSA until the month that individual becomes enrolled in Medicare. (Notice 2004-50, 2, 2004-33 IRB 196, §1)

Medicare Part A coverage begins the month an individual turns age 65, provided the individual files an application for Medicare Part A (or for Social Security or Railroad Retirement Board benefits) within six months of the month in which the individual becomes age 65. If the individual files an application more than six months after turning age 65, Medicare Part A coverage will be retroactive for six months. Individuals who delayed applying for Medicare, but were later covered by Medicare retroactively to the month they turned 65 (or six months, if later), cannot make contributions to the HSA for the period of retroactive coverage.

The information letter concerned an individual who had been contributing to his HSA and then enrolled in Medicare, which was made retroactive (either to the month he turned 65 or six months, if later). The retroactive enrollment made the individual ineligible to contribute to his HSA for that period. The individual presumably made contributions that exceeded the maximum annual contribution amount ("excess contributions"), as reduced to reflect the retroactive effect of his Medicare enrollment.

The individual was concerned that he would face a penalty for contributing to the HSA while enrolled.

IRS stated in the letter that individuals cannot make contributions to an HSA for the period of retroactive coverage and that there are no exceptions to this rule. They may, however, avoid the penalty by withdrawing the excess contributions (and any net income attributable to the excess contribution) from the HSA by the due date for the return (with extensions). An individual generally may withdraw amounts from an HSA after reaching the age for Medicare eligibility without penalty. Both types of withdrawals must be included in income for federal tax purposes to the extent the amounts were previously excluded from taxable income.

If an excess contribution is not withdrawn by the due date of the federal tax return for the tax year, it is subject to an excise tax under §4973, which is intended to recapture the benefits of any tax-free earning on the excess contribution.

IRS reasoned that the ability to contribute to HSAs is limited to individuals whose only coverage is provided through a HDHP, such that the HSA is available to help pay for the medical expenses incurred before the deductible is satisfied. If an individual has coverage that is not subject to the full deductible of the HDHP (other than coverage for preventive care), even if retroactive, the individual is not allowed to contribute to the HSA.

Information Letter 2016-0072.

A plan administrator may require its employees to receive required minimum distributions (RMDs) on a date specified in the retirement plan document or a date the administrator chooses. The administrator does not have to permit the individual to provide the date on which he or she wants to receive the payment.

The required beginning date (RBD) for an IRA owner-i.e., the date that RMDs must commence-is April 1 of the year following the year in which the owner attains age 70 ½. (§401(a)(9)(C)(i)(I); Regulation §1.408-8, Q&A 3) A person reaches age 70½ as of the date that is six calendar months after the 70th anniversary of his birth. (Regulation §1.401(a)(9)-2, Q&A 3)

A participant in a qualified retirement plan (e.g., 401(k) plan) must begin taking distributions from the plan by April 1 of the calendar year following the later of the year in which he: (a) reaches age 70 ½, or (b) retires (except for 5% owners, who are subject to the same rules as IRA owners). However, note that a qualified plan may provide that the RBD for all employees (including non-5% owners) is April 1 of the calendar year following the calendar year in which the employee attains age 70 ½. (§401(a)(9)(C); Regulation §1.401(a)(9)-2, Q&A 2(e)) The account balance, which is divided by a life-expectancy factor to determine annual lifetime non-annuity RMDs, is the balance in the IRA or qualified plan account at the end of the year before the distribution year, i.e., the year for which the RMD is being determined. (Regulation §1.408-8, Q&A 6)

The amount of each RMD is calculated separately for each IRA. However, the RMD amounts for the separate IRAs may be totaled, and the aggregated RMD amount may be paid out from any one or more of the IRA accounts. (Regulation §1.408-8, Q&A 9) The rule permitting amounts in traditional IRAs to be aggregated for RMD purposes applies only to IRAs that an individual holds as an owner. It does not apply to IRAs that an individual holds as a beneficiary. IRAs held by a person as a beneficiary of the same decedent may be aggregated, but cannot be aggregated with amounts held in IRAs that the individual holds as the IRA owner or as the beneficiary of another decedent. And no traditional IRA can be aggregated with a qualified retirement plan account or a Roth IRA to determine payouts. (Regulation §1.408-8, Q&A 9)

In general, the term "first distribution calendar year" means the year in which the IRA or qualified plan account owner attains age 70-½ and in respect to which the first RMD is made. (Regulation §1.401(a)(9)-2, Q&A 2) The taxpayer may postpone the first distribution calendar year's RMD until the second distribution calendar year (i.e., make the first-year RMD by April 1 of the second year). However, non-5% company owners who continue working may defer RMDs until April 1 following the year they retire). (§408(b)(3), §401(a)(9)(C)) But taking advantage of the three-month "grace period" for the first distribution year's RMD does not absolve the taxpayer from making an RMD for the second distribution calendar year. (Regulation §1.401(a)(9)-5, Q&A1(c))

The distribution required to be made on or before the employee's RBD is treated as the distribution required for the employee's first distribution calendar year. The RMD for other distribution calendar years, including the RMD for the distribution calendar year in which the taxpayer's RBD occurs, must be made on or before the end of that distribution calendar year. (Regulation §1.401(a)(9)-5, Q&A 1(c))

A constituent of Sen. John Cornyn (R-TX) wanted to know whether an employer may require its employees to receive an RMD on a date the employer specifies, or whether the employer must allow the individual to provide the date upon which the individual wants to receive the payment. Sen. Cornyn's office in turn asked IRS to supply guidance.

Observation: This would have a practical difference to a person who is not depending on the RMD for living expenses, and who wants to keep the retirement cash earning money in the account for as long as possible. Such a person may want to take each year's RMD in December, while the employer may want to pay it out in, say, January of each year. Alternatively, a taxpayer who relies on an RMD for living expenses during retirement may prefer to receive it in monthly increments, while the employer may want to pay it out in one lump sum.

The Information Letter to Sen. Cornyn points out that the tax rules do not specify a date during the calendar year when the payment must be made, nor do they specify which party determines the date on which payment will be made. The retirement plan document may specify such terms or, if it does not, the procedures for payment of a requested RMD generally would be within the discretion of the plan administrator.

Observation: In other words, if the plan administrator or plan document mandates a specific date for paying out each year's RMD, the plan participant is stuck with it.

Observation: If receiving RMDs on a specific date or on a specific schedule is important enough to the plan participant, he or she can simply execute a direct rollover of the retirement plan proceeds to an IRA with an accommodating financial institution and then tell the IRA trustee how to disburse each year's RMD.

Information Letter 2016-0071.

An individual on the consequences of a Roth IRA non-spouse beneficiary's failure to timely begin taking the required minimum distributions (RMDs) under §401(a)(9) 's "life expectancy rule." The individual asked whether a non-spouse beneficiary's failure to begin such distributions within one year of the Roth IRA owner's death made the life expectancy rule inapplicable and required that distributions be made under §401(a)(9) 's "five year rule."

Employer-provided defined contribution qualified retirement plans, traditional IRAs and individual retirement annuities are subject to the RMD rules. Generally, RMDs must begin by the required beginning date, which usually is April 1 of the calendar year following the calendar year in which the individual (employee or IRA owner) reaches age 70½.

§4974 imposes a 50% excise tax on any amounts that were required to be distributed under §401(a)(9) but were not timely distributed, unless the imposition of such tax is waived.

Roth IRAs are not subject to the RMD rules of §401(a)(9)(A). However, the post-death RMD rules (which apply to traditional IRAs), also apply to Roth IRAs, with the exception of the "at-least-as-rapidly" rule (i.e., the rule requiring that the remaining portion of the participant's (or the Roth IRA owner's) interest be distributed at least as rapidly as under the method of distribution that was in effect at the date of the owner's death, under §401(a)(9)(B)(i)). (§408A(c)(5))

Thus, the entire interest in the Roth IRA must be distributed:

1. By the end of the fifth calendar year after the year of the owner's death (the "5-year rule"); or

2. To a designated beneficiary over a period of not greater than that beneficiary's life expectancy, and distribution must begin before the end of the calendar year following the year of death. (Regulation §1.408A-6, Q&A 14(a))

Under §401(a)(9), the treatment of minimum distributions after the death of a traditional IRA owner depend on whether he died before or after his required beginning date and whether or not he designated a beneficiary. Where the death is before the required beginning date:

a. If the IRA owner designated a nonspouse beneficiary for the account, there are two methods for satisfying the after-death RMD rules: (1) Under the 5-year rule, the individual's entire account must be distributed no later than December 31 of the calendar year containing the fifth anniversary of his death; (§401(a)(9)(B)(ii)) (2) Under the life expectancy method, annual RMDs over the beneficiary's life, or over a period not extending beyond his life expectancy, must begin no later than December 31 of the calendar year immediately following the calendar year in which the individual died. (§401(a)(9)(B)(iii); §408(a)(6))

b. If he did not designate a beneficiary for the IRA, the remaining balance in the IRA must be distributed no later than December 31 of the calendar year which contains the fifth anniversary of the date the owner died. (§401(a)(9)(B)(ii); Regulation §1.401(a)(9)-3, Q&A 1(a); Regulation §1.401(a)(9)-3, Q&A 2)

A plan may contain a provision that allows employees (or beneficiaries) to elect, on an individual basis, whether the 5-year rule or the life expectancy rule applies to distributions after the death of an employee who has a designated beneficiary. An employee's election between the 5-year rule and the life expectancy rule must be made no later than the earlier of: (1) December 31 of the calendar year in which distribution would have to start in order to satisfy the requirements for the life expectancy rule, or (2) December 31 of the calendar year which contains the fifth anniversary of the employee's death. As of the last date the election may be made, the election must be irrevocable with respect to the beneficiary (and all subsequent beneficiaries) and must apply to all later years. (Regulation §1.401(a)(9)-3, Q&A 4(c))

In the Information Letter, IRS noted that post-death distributions from a Roth IRA to a designated beneficiary generally must be made in accordance with the RMD rules under §401(a)(9)(B) as if the Roth IRA owner died before his or her required beginning date. Under these rules, if an employee dies before the employee's required beginning date, distribution of the employee's entire interest must be made either (1) in full within five years of the employee's death (i.e., under the 5-year rule), or (2) over a period not extending beyond the beneficiary's life expectancy, beginning within one year of the employee's death (the life expectancy rule). Special rules apply if the beneficiary is the employee's spouse.

IRS noted that whether the life expectancy rule or the 5-year rule applies in a particular situation is governed by Regulation §1.401(a)(9)-3, Q&A 4. The regulations provide that if there is a designated beneficiary, distributions are to be made in accordance with the life expectancy rule, unless the terms of the plan either (a) require that distributions be made under the 5-year rule, or (b) allow the beneficiary to elect to use the 5-year rule. If the plan permits such elections by the beneficiary, the life expectancy rule will apply unless the beneficiary makes such election within a specific time period, or the plan provides that distributions will be made under the 5-year rule if no such election is made. The determination of which distribution period applies is made in accordance with these rules, and is not based on whether distributions begin timely under the applicable rule.

In addition, IRS explained that a taxpayer may request a waiver of the §4974 excise tax by attaching a statement of explanation and completing Form 5329 (Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts) as instructed under Waiver of tax in the Instructions for Form 5329.

Notice 2017-49, 2017-40 IRB

IRS, the Department of Labor's Employee Benefits Security Administration (EBSA), and the Pension Benefit Guaranty Corporation (PBGC) have provided relief in connection with certain employee benefit plans because of damage caused by Hurricane Harvey and Hurricane Irma. In general, the Notice extends a number of deadlines associated with employee plans to January 31, 2018.

Under §7508A(b), in the case of a pension or other employee benefit plan-or any sponsor, administrator, participant, beneficiary, or other person with respect to such plan-that is affected by a disaster or a terroristic or military action, IRS may specify a period of up to one year which may be disregarded in determining the date by which any action is required or permitted to be completed under the Code. In addition, a plan is not treated as failing to be operated under the terms of the plan solely as the result of disregarding any period designated by IRS.

An employer that sponsors a single-employer pension plan must satisfy the minimum funding standard for a plan year. (§412(a); ERISA §302(a)) For most single-employer plans, the minimum funding standard is satisfied for a plan year if the employer contributes the minimum required contribution determined under §430 and ERISA §303 (or, in the case of a money purchase plan, the contributions that are required under the terms of the plan) for the plan year. The minimum required contribution for a plan year must be paid within 8-½ months after the close of the plan year. (§430(j)(1); ERISA §303(j)(1))

§430(f) provides rules regarding a plan's maintenance of a prefunding balance and a funding standard carryover balance, including rules permitting the use of those balances to offset the minimum required contribution. Elections with respect to a plan's prefunding balance and funding standard carryover balance must be made under timing rules set out in Regulation §1.430(f)-1(f)(2).

The minimum funding requirements may be waived in the event of temporary substantial business hardship. (§412(c); ERISA §302(c)) For a plan other than a multiemployer plan, an application for such a waiver must be submitted by the 15th day of the 3rd month beginning after the close of the plan year for which the waiver is sought. (§412(c)(5); ERISA §302(c)(5))

If a single-employer defined benefit plan had a funding shortfall for the preceding plan year, the plan sponsor maintaining the plan is required to make four quarterly installment payments in order to pay §430 minimum required contributions for the plan year. (§430(j)(3)(A)) Late quarterly installments are subject to a higher rate of interest (§430(j)(3); ERISA §303(j)(3)), and the quarterly installments are increased under §430(j)(4) and ERISA §303(j)(4) to the amount needed to prevent a liquidity shortfall (as defined in those sections). For a plan year, the due dates for the required installments are the 15th day of the 4th, 7th, and 10th plan months, and the 15th day after the end of the plan year.

For certain plans with a "funding target attainment percentage" of less than 100% for the plan year, a lien arises in favor of the plan if the required installments or any other payment required under §430 and ERISA §303 are not made to the plan before the due date for the required installment or other payment and if the aggregate unpaid balance of required installments and other payments exceeds $1 million. (§430(k); ERISA §303(k)) If this lien arises, the plan sponsor is required to notify PBGC within 10 days of the failure.

§436 and ERISA §206(g) impose certain benefit restrictions that are applied based on a plan's adjusted funding target attainment percentage (AFTAP) for the plan year. For this purpose, a plan's AFTAP for the plan year is conclusively presumed to be less than 60% from the first day of the 10th month of the plan year through the end of the plan year if no certification of the AFTAP for the plan year is made before the first day of the 10th month of the plan year. (§436(h)(2); ERISA §206(g)(7)(B)) In certain cases in which no certification of the AFTAP for a plan year is made before the first day of the 4th month of the plan year, the plan's AFTAP is presumed to be equal to ten percentage points less than the AFTAP for the preceding plan year for a period beginning on the first day of the 4th month. (§436(h)(3); ERISA §206(g)(7)(C))

The plan administrator of a single-employer plan must provide written notice to participants and beneficiaries within 30 days after the date the plan has become subject to a benefit restriction under ERISA §206(g)(1) (under which the payment of certain unpredictable contingent event benefits is restricted) or ERISA §206(g)(3) (under which the payment of certain accelerated benefit distributions is restricted). (ERISA §101(j)(1)) For a single-employer plan under which benefit accruals are restricted under ERISA §206(g)(4) because the plan's AFTAP is less than 60%, the plan administrator must provide written notice to participants and beneficiaries within 30 days after the earlier of (i) the plan's valuation date, or (ii) the date the AFTAP is presumed to be less than 60% for the plan year pursuant to ERISA §206(g)(7)(B). (ERISA §101(j)(2))

Under PBGC's premium regulations, contribution receipts for a plan year (as described in ERISA §303(g)(4)) are included in the market value of assets as of the valuation date to the extent received by the plan by the date the premium is filed. (29 CFR §4006.4(c)) In addition, reporting requirements under Title IV of ERISA arise from certain late contributions. (29 CFR Secs. 4043.25 and 4043.81) §432(b)(3)(A) and ERISA §305(b)(3)(A) provide special rules for certain multiemployer defined benefit plans. For a plan that is subject to those requirements, the plan actuary must make certain certifications each year, by the 90th day of the plan year, regarding the plan's funded status. In certain circumstances, the plan sponsor is required to provide notice regarding the plan's funded status to participants and beneficiaries, the bargaining parties, PBGC, the Secretary of Labor, and, if applicable, the Secretary of the Treasury. (§432(b)(3)(D); ERISA §305(b)(3)(D)) For the first plan year that a multiemployer plan is in endangered status, the plan sponsor must adopt a funding improvement plan no later than 240 days following the required date for the actuarial certification of endangered status. (§432(c)(1); ERISA §305(c)(1)) For the first plan year that a multiemployer plan is in critical status, the plan sponsor must adopt a rehabilitation plan no later than 240 days following the required date for the actuarial certification of critical status. (§432(e)(1); ERISA §305(e)(1))

Pursuant to §7508A(b), IRS provided relief to "Affected Plans," defined as a plan with any of the following located in the "Affected Area" (i.e., any of the Texas counties identified for individual assistance by FEMA on account of Hurricane Harvey, and any of the Florida counties identified for individual assistance by FEMA because of Hurricane Irma, and any other areas so identified because of either storm):

1. The principal place of business of the employer that maintains the plan (in the case of a plan covering employees of one employer, determined disregarding the rules of §414(b) and §414(c));

2. The principal place of business of employers that employ more than 50% of the active participants covered by the plan (in the case of a plan covering employees of more than one employer, determined disregarding the rules of §414(b) and §414(c));

3. The relevant office of the plan or the plan administrator;

4. The relevant office of the primary record keeper serving the plan; or

5. The office of the enrolled actuary or other advisor that previously had been retained by the plan or the employer to make funding determinations or certifications for which the due date falls between the date specified by FEMA as the beginning of the incident period (also referred to as the "Initial Relief Date"-generally, when the storm began) and January 31, 2018.

For a single-employer defined benefit plan (other than a "cooperative and small employer charity" (CSEC) plan under §414(y)) that is an Affected Plan, if the date described for performing the acts described below falls within the period beginning on the Initial Relief Date and ending on January 31, 2018, then the date for performing such an act is postponed to January 31, 2018:

1. The date described in §430(j)(1) or §430(j)(3) and ERISA Secs. 303(j)(1) or 303(j)(3) for making a contribution for a plan year;

2. The date specified in Regulation §1.430(f)-1(f)(2) for making an election relating to such a plan's prefunding balance or funding standard carryover balance; and

3. The date described in §436(h)(2) or §436(h)(3) and ERISA Secs. 206(g)(7)(B) or 206(g)(7)(C) for certification of the AFTAP.

For any CSEC plan that is an Affected Plan, if the date described for performing the acts described below falls within the period beginning on the Initial Relief Date and ending on January 31, 2018, then the date for performing such an act is postponed to January 31, 2018:

1. The date described in §433(c)(9) or §433(f) and ERISA Secs. 306(c)(9) or 306(f) for making a contribution for a plan year;
2. The date described in §433(j)(4) and ERISA §306(j)(4) by which the plan actuary must make the required certification; and

3. The deadline described in §433(j)(3) and ERISA §306(j)(3) by which a plan sponsor of such an Affected Plan that is in funding restoration status must adopt a funding restoration plan.

For any single-employer plan that is an Affected Plan, if the deadline for furnishing a notice required under ERISA Secs. 101(j)(1) or 101(j)(2) falls within the period beginning on the Initial Relief Date and ending on January 31, 2018, then the date by which that notice must be furnished is postponed to January 31, 2018.

The relief described above applies under Title IV of ERISA for purposes of determining the timeliness of a contribution and whether that contribution is included in market value of assets.

For any multiemployer plan that is an Affected Plan, if the date described for performing the acts described below falls within the period beginning on the Initial Relief Date and ending on January 31, 2018, then the date for performing such an act is postponed to January 31, 2018:

1. The date described in §432(b)(3)(A) and ERISA §305(b)(3)(A) by which the plan actuary must make any certification required under §432(b)(3)(A); and

2. The deadline described in §432(c)(1) or §432(e)(1) and ERISA Secs. 305(c)(1) or 305(e)(1) by which a plan sponsor of such an Affected Plan that is in endangered or critical status must adopt or update a funding improvement plan or a rehabilitation plan. However, if the date by which a certification of such an Affected Plan's status is postponed in accordance with this relief, then the date described in §432(c)(1) or §432(e)(1) and ERISA Secs. 305(c) or 305(e) by which the plan sponsor of such an Affected Plan that is in critical or endangered status must adopt a funding improvement plan or a rehabilitation plan nonetheless continues to be determined based on the original deadline for the certification of the plan's status.

With respect to a plan that is an Affected Plan, if the deadline described in §412(c)(5) and ERISA §302(c)(5) for applying for a waiver for an Affected Plan falls within the period beginning on the Initial Relief Date and ending on January 31, 2018, then that deadline is postponed to January 31, 2018.
Other Harvey-and Irma-related tax relief

Notice 2017-45, 2017-38 IRB

IRS has extended for one more year previously provided temporary relief with respect to the rules that require that qualified plans not discriminate in favor of highly compensated employees (HCEs). If certain conditions are met, the relief now applies for plan years beginning before 2019 for certain "closed" defined benefit pension plans (i.e., defined benefit plans that provide ongoing accruals but that have been amended to limit those accruals to some or all of the employees who participated in the plan as of a specified date).

§410(b) generally provides that a plan is a qualified plan only if the classification of employees who benefit under the plan does not discriminate in favor of HCEs. §410(b)(6)(B) provides that two or more plans can be aggregated for purposes of satisfying §410(b), but only if those plans are also aggregated for purposes of §401(a)(4).

§401(a)(4) generally provides that a plan is a qualified plan only if the contributions or the benefits provided under the plan do not discriminate in favor of HCEs. Compliance with §401(a)(4) can generally be demonstrated on the basis of either contributions or benefits. Regulation §1.401(a)(4)-9(b) contains special rules that apply for purposes of determining whether an aggregation of plans that includes one or more defined benefit (DB) plans and one or more defined contribution (DC) plans (referred to as a DB/DC plan) satisfies the requirements of §401(a)(4).

A DB/DC plan can demonstrate compliance with §401(a)(4) on the basis of equivalent benefits only if the DB/DC plan satisfies one of three alternative conditions, specifically that the plan: (1) be primarily defined benefit in character; (2) consist of broadly available separate plans; or (3) meet the minimum aggregate allocation gateway. The second of these criteria is met if the DB and DC plans each meet discrimination tests. The third is met if each non-highly compensated employee (NHCE) in the DB/DC plan has a minimum aggregate normal allocation rate that is a defined percentage of the aggregate normal allocation rate of the HCE in the aggregated plans who has the highest aggregate normal allocation rate. (Regulation §1.401(a)(4)-9(b)(2)(v)).

Regulation §1.401(a)(4)-1(d) provides that IRS may, in revenue rulings, notices, etc., provide any additional guidance that may be necessary or appropriate in applying the nondiscrimination requirements of §401(a)(4), including additional safe harbors and alternative methods and procedures for satisfying those requirements.

A number of DB plans have been closed to new entrants. The plan sponsor of a closed DB plan typically provides a DC plan for its new hires. Under these arrangements, in the early years after the DB plan has been closed to new entrants, the plan may be able to satisfy the coverage requirement of §410(b) without being aggregated with the DC plan. However, the §410(b) minimum coverage test typically becomes more difficult for the closed DB plan to satisfy over time, as the proportion of plan participants who are HCEs increases. This might occur for several reasons, including the tendency of nonhighly compensated employees (NHCEs) to have higher rates of turnover than HCEs, as well as the potential for some of the NHCEs in the closed plan to become HCEs as they continue employment and their pay increases.

If the closed DB plan cannot satisfy the coverage requirement of §410(b) on its own, it will need to be aggregated with another plan in order to satisfy that coverage requirement. If the DB plan is aggregated with a DC plan that covers the employer's new hires to satisfy the coverage requirement, then it is also required to be aggregated with the DC plan for purposes of satisfying the nondiscrimination requirements of §401(a)(4). In the typical case, the aggregated plans will fail the requirements of §401(a)(4) unless they are permitted to demonstrate compliance with the nondiscrimination requirements on the basis of equivalent benefits.

The aggregated plans usually will be permitted to demonstrate nondiscrimination on the basis of equivalent benefits in the initial years of aggregation, because the aggregated plans will either be primarily defined benefit in character or consist of broadly available separate plans. However, the same demographic forces that drive the increase in the proportion of HCEs in the closed plan might also over time lead to the aggregated plans being neither primarily defined benefit in character nor consisting of broadly available separate plans. When this occurs, the aggregated plans will be permitted to demonstrate nondiscrimination on the basis of equivalent benefits only if the plans satisfy the minimum aggregate allocation gateway.

In many cases, the DC plan provides sufficient allocations to enable the DB/DC plan to satisfy the nondiscrimination requirements on the basis of equivalent benefits if the DB/DC plan were permitted to demonstrate satisfaction of the nondiscrimination requirements on that basis. However, the DC plan may not provide for allocations that satisfy the minimum aggregate allocation gateway. If the DB/DC plan does not meet any of the three alternative conditions for testing on the basis of equivalent benefits, then the DB/DC plan is not permitted to demonstrate satisfaction of the nondiscrimination requirements on that basis.

In December of 2013, IRS issued Notice 2014-5, 2014-2 IRB 276, which provided temporary nondiscrimination relief for certain "closed" DB pension plans for plan years beginning before 2016. Notice 2014-5, §III.B allowed a DB/DC plan that included a closed DB plan (that was closed before December 13, 2013), and that satisfied certain conditions set out in Notice 2014-5, to demonstrate satisfaction of the nondiscrimination in amount requirement under Regulation §1.401(a)(4)-1(b)(2) on the basis of equivalent benefits, even if the DB/DC plan did not meet any of the existing eligibility conditions for testing on that basis under Regulation §1.401(a)(4)-9(b)(2)(v).

Under this alternative, the DB/DC plan could make that demonstration on the basis of equivalent benefits for a plan year that begins before Jan. 1, 2016, if it included a DB plan providing ongoing accruals that was amended (by an amendment adopted before December 13, 2013) to provide that only employees who participated in the DB plan on a specified date continued to accrue benefits under the plan, and if each of the DB plans in the DB/DC plan satisfied one of the following conditions:

1. For the plan year beginning in 2013, the DB plan was part of a DB/DC plan that either was primarily defined benefit in character or consisted of broadly available separate plans; or

2. In the case of a DB plan that was amended (by an amendment adopted before December 13, 2013) to provide that only employees who participated in the DB plan on a specified date continue to accrue benefits under the plan, the DB plan was not part of a DB/DC plan for the plan year beginning in 2013 because the DB plan satisfied the coverage and nondiscrimination requirements without aggregation with any DC plan.

Notice 2015-28, 2015-14 IRB 848 extended the temporary nondiscrimination relief provided in Notice 2014-5 for an additional year by applying that relief to plan years beginning before 2017, if the conditions in Notice 2014-5 were satisfied. Notice 2016-57, 2016-40 IRB 432 provided an additional extension, to plan years beginning before 2018.

During the period for which this extension applied, the remaining provisions of the nondiscrimination regulations under §401(a)(4) (including the rules relating to the timing of plan amendments under Regulation §1.401(a)(4)-5) continued to apply.

In late January of 2016, IRS issued proposed regulations on the nondiscrimination requirements for closed plans. The proposed regulations set out relief for closed plans under Regulation §1.401(a)(4)-4, Regulation §1.401(a)(4)-8, and Regulation §1.401(a)(4)-9 (subject to satisfaction of certain conditions set out in the regulations) and contain other proposed nondiscrimination rules. The proposed regulations would generally apply to plan years beginning on or after the date of publication of the final regulations, but taxpayers are permitted to apply certain provisions earlier (including all of the provisions that apply specifically to closed plans).

It is anticipated that the final regulations will not be published in time for plan sponsors to make plan design decisions based on the final regulations before expiration of the relief provided under Notice 2014-5 (as extended by Notice 2016-57). Accordingly, IRS has determined that it is appropriate to extend the relief provided under Notice 2014-5 for an additional year.

New Notice 2017-45 provides that the temporary nondiscrimination relief for closed plans that is provided in Notice 2014-5 is extended to plan years beginning before 2019 if the conditions of Notice 2014-5 are satisfied. This extension is provided in anticipation of the issuance of final amendments to the §401(a)(4) regulations. In addition, it is intended that the final regulations will provide that the reliance granted in the preamble to the proposed regulations may be applied for plan years beginning before 2019.

Notice 2017-44, 2017-36 IRB.

Model amendments that a sponsor of a qualified defined benefit (DB) plan may use to amend its plan document to offer bifurcated benefit distribution options to participants in accordance with final regulations issued under §417(e).

§417 and its regulations provide rules on survivor annuity forms of distribution that must be offered under qualified DB plans, including restrictions on cash-outs under §417(e). Under §417(e)(3) 's "minimum present value requirements," in determining the present value of a participant's accrued benefit for distribution, the present value of the benefit cannot be less than the present value determined by using the applicable mortality table and the applicable interest rate.

Under Regulation §1.417(e)-1(d)(6), an exception from the minimum present value requirements applies to a distribution paid in the form of an annuity that does not decrease during the life of the participant (other than specified permitted decreases). If an optional form of benefit is eligible for this exception, the requirement to use the §417(e)(3) actuarial assumptions to determine the amount of the benefit payable in the optional form does not apply, and the actuarial assumptions that are used for this purpose must instead satisfy the requirements of §411(a) that they not result in an impermissible forfeiture of the accrued benefit.

To encourage sponsors of plans that include single sum distribution options to offer participants the additional option to bifurcate their benefits in order to receive a portion in an annuity form (providing financial protection against unexpected longevity) and the remainder in an accelerated form (providing increased liquidity during retirement), IRS amended the §417(e) regulations in September 2016 to allow plans to simplify the calculation of the amount of certain optional forms of benefit. Regulation §1.417(e)-1(d)(7) provides rules under which the participant's accrued benefit may be "bifurcated" (into two or more parts), so that the minimum present value requirements of §417(e)(3) apply only to the portion of the participant's accrued benefit that is paid in the accelerated form. Regulation §1.417(e)-1(d)(7) applies to distributions with annuity starting dates in plan years beginning on or after January 1, 2017, or, if the taxpayer elects, to earlier periods.

Regulation §1.417(e)-1(d)(7)(ii)(A) and Regulation §1.417(e)-1(d)(7)(ii)(B) provide two acceptable bifurcation methods that a plan sponsor may choose to include in plan terms: explicit and implicit. Under the explicit bifurcation method, a plan allows a participant to elect to divide his or her accrued benefit into two or more portions, and the minimum present value rules of §417(e)(3) are applied separately to each portion of the accrued benefit as if it were the participant's entire benefit.

Under the implicit bifurcation method, a plan permits a participant to elect the payment of a single-sum amount if the remaining portion of the participant's accrued benefit is no less than the total accrued benefit reduced by the actuarial equivalent of the single sum (determined using the actuarial assumptions that apply under §417(e)(3)).

Regulation §1.417(e)-1(d)(7)(iii) sets out rules of operation for these bifurcation methods, including rules describing certain circumstances under which the implicit bifurcation method is not available.

Regulation §1.417(e)-1(d)(7)(iv) provides that §411(d)(6) is not violated as a result of an amendment to a plan to implement a bifurcated distribution option if certain conditions are satisfied. This relief applies with respect to a plan amendment adopted on or before December 31, 2017, if, for plan years beginning before January 1, 2017, the §417(e)(3) applicable interest rate and applicable mortality table were used to calculate the amount of a distribution that was made to settle a portion of the accrued benefit under the plan, and, pursuant to Regulation §1.417(e)-1(d)(7), the requirements of §417(e)(3) and Regulation §1.417(e)-1(d) are not required to be applied to the distribution.

The Appendix to Notice 2017-44 provides model language that may be used for each of the above methods. The model language provides for the payment of the minimum amounts required to be paid in order to comply with the rules of Regulation §1.417(e)-1(d)(7). A plan may provide for amounts that exceed the minimum amounts required to be paid pursuant to Regulation §1.417(e)-1(d)(7), but the treatment specified under Notice 2017-44, §III.A , does not apply to a plan amendment that differs from the model language in order to provide greater amounts.

Although a plan sponsor may use the model language in Notice 2017-44 to provide a bifurcated distribution option to participants in accordance with the final regulations, a plan that provides for a bifurcated distribution option is not required to include this specific model language. The sponsor of a plan that currently provides for bifurcated distributions under plan terms that comply with the provisions of Regulation §1.417(e)-1(d)(7) (relating to either implicit or explicit bifurcation) does not need to amend those plan terms. In addition, use of the model language by an employer that has adopted a pre-approved plan will not cause the plan to fail to be identical to the pre-approved plan.

The model amendments set out in the Appendix may be used to implement either of the two methods set out in Regulation §1.417(e)-1(d)(7) for computing the amount to be paid to a participant who elects to receive his or her accrued benefit in an optional form of payment consisting partially of an annuity and partially of a more accelerated form of payment. However, the implicit bifurcation amendment may not be used with respect to distributions for which Regulation §1.417(e)-1(d)(7)(iii)(C) prohibits the use of implicit bifurcation.

If the conditions set out in Notice 2017-44, §III.B, are satisfied, Notice 2017-44, §III.A, provides that:

a. Adoption of a plan amendment incorporating the language in either of the model amendments in accordance with Notice 2017-44 will not cause a plan to violate the requirements of §417(e) and Regulation §1.417(e)-1(d)(7);

b. Such a plan amendment that is adopted on or before December 31, 2017, is eligible for the limited relief from the application of the anti-cutback provisions of §411(d)(6) provided under Regulation §1.417(e)-1(d)(7)(iv); and

c. In the case of a pre-approved plan, if one of these model amendments is adopted by an adopting employer rather than by the sponsor/practitioner/provider, the adoption of the amendment will not cause the plan to fail to be identical to the pre-approved plan.

A plan sponsor may modify the language of a model amendment without affecting the treatment described in Notice 2017-44, §III.A, to conform the language of the model amendment to the plan's terminology or organization or to satisfy the conditions set forth in Notice 2017-44, §III.B.3, provided that the modifications do not alter the meaning of any of the provisions of the model amendment. In addition, in the case of a pre-approved plan, some portions of the model amendment may be included in the basic plan document, and others may be included in the adoption agreement, as appropriate.

Plan sponsors may limit the extent to which bifurcation is available with respect to a participant's accrued benefit, specify the number of forms of distribution among which an accrued benefit may be bifurcated, or limit the combinations of forms that are available for this purpose. Notice 2017-44, §III.D, provides examples of some of the ways in which plan terms may limit the bifurcation of a participant's accrued benefit.

Notice 2017-20, 2017-11 IRB.

IRS has extended the period for an employer to furnish an initial written notice to its eligible employees regarding a qualified small employer health reimbursement arrangement (QSEHRA) under §9831(d).

Under §9831(d), which was added to the Code by the 21st Century Cures Act (Cures Act, P.L. 114-255, 12/13/2016), an eligible employer-generally an employer with fewer than 50 full-time employees, including full-time equivalent employees, that does not offer a group health plan to any of its employees-may provide a QSEHRA to its eligible employees. §9831(d)(1) provides that a QSEHRA will not be treated as a group health plan.

Observation: Thus, a QSEHRA is not subject to the Code's group health plan requirements-including the group health plan portability, access, and renewability requirements initially enacted as part of the Health Insurance Portability and Accountability Act of 1996 (HIPAA), and the market reform provisions enacted by the Affordable Care Act (ACA).

Under a QSEHRA, after an eligible employee provides proof of coverage, payments or reimbursements may be made to that eligible employee for expenses for medical care (as defined in §213(d) and including expenses for premiums for individual health insurance policies) incurred by the eligible employee or the eligible employee's family members, if certain requirements are satisfied.

§9831(d)(4) generally requires an eligible employer to furnish a written notice to its eligible employees at least 90 days before the beginning of a year for which the QSEHRA is provided (or, in the case of an employee who is not eligible to participate in the arrangement as of the beginning of such year, the date on which such employee is first so eligible). Under §9831(d)(4)(B), the written notice must include:

1. A statement of the amount that would be the eligible employee's permitted benefit under the arrangement for the year. A "permitted benefit" is, with respect to any eligible employee, the maximum dollar amount of payments and reimbursements which may be made under the terms of the qualified small employer health reimbursement arrangement for the year with respect to such employee. (§9831(d)(3)(C);

2. A statement that the eligible employee should provide the information described in clause (i) to any health insurance exchange to which the employee applies for advance payment of the premium tax credit; and

3. A statement that if the eligible employee is not covered under minimum essential coverage for any month, the employee may be liable for an individual shared responsibility payment under §5000A for that month and reimbursements under the arrangement may be includible in gross income.

§6652(o), which was also added to the Code by the Cures Act, imposes a penalty for failing to timely furnish eligible employees with the required written QSEHRA notice. This penalty applies for years beginning after December 31, 2016. An eligible employer that provides a QSEHRA to its eligible employees for a year beginning in 2017 will not be treated as failing to timely furnish the initial written notice if the notice is furnished to its eligible employees no later than 90 days after the Cures Act's enactment (that is, no later than March 13, 2017). (Section 18001(a)(7) of the Cures Act)

Notice 2017-20 provides that an eligible employer that provides a QSEHRA to its eligible employees for a year beginning in 2017 is not required to furnish the initial written notice to those employees until after further guidance has been issued by IRS. That further guidance will specify a deadline for providing the initial written notice that is no earlier than 90 days following the issuance of that guidance.

In addition, no §6652(o) penalties will be imposed for failure to provide the initial written notice before the extended deadline specified in that guidance. Employers that furnish the QSEHRA notice to their eligible employees before further guidance is issued may rely upon a reasonable good faith interpretation of the statute to determine the contents of the notice.

Notice 2017-15, 2017-6 IRB.

Guidance on the application of the Supreme Court's Windsor decision and Revenue Ruling 2013-17 to the rules regarding the applicable exclusion amount under §2010(c) and §2505, and the generation-skipping transfer (GST) exemption under §2631, as they relate to certain gifts, bequests, and GSTs by or to same-sex spouses. The Notice sets out special administrative procedures under which certain taxpayers and the executors of certain taxpayers' estates can recalculate a taxpayer's remaining applicable exclusion amount and remaining GST exemption to the extent an allocation of that exclusion or exemption was made to certain transfers made while the taxpayer was married to a person of the same sex.

§2001(a) imposes an estate tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the U.S. A credit of the "applicable credit amount"-i.e., the amount of the tentative tax that would be imposed on the "applicable exclusion amount"-is allowed to the estate of every decedent against the tax imposed by §2001. (§2010(a)) The applicable exclusion amount is the sum of the basic exclusion amount ($5 million, as increased for inflation) and the deceased spousal unused exclusion (DSUE) amount. (§2010(c)) In general, the value of the decedent's taxable estate is determined by deducting from the value of the gross estate the value of all interests in property passing from the decedent to the surviving spouse. (§2056(a))

§2501 imposes a gift tax for each calendar year on the transfer of property by gift during such calendar year by any individual equal to the excess of: (1) a tentative tax computed under §2001(c) on the aggregate sum of the taxable gifts for such calendar year and for each of the preceding calendar periods, over (2) a tentative tax computed under §2001(c) on the aggregate sum of the taxable gifts for each of the preceding calendar periods. (§2502) In the case of a citizen or resident of the U.S., a credit is allowed against the tax imposed by §2501 for each calendar year in an amount equal to (1) the applicable credit amount in effect under §2010(c) that would apply if the donor died at the end of the calendar year, reduced by (2) the sum of the amounts allowable as a credit to the individual under §2505 for all preceding calendar periods. (§2505(a)) In general, the amount of the donor's taxable gifts for that calendar year is generally reduced by the total value of gifts to the donor's spouse. (§2523(a))

A taxpayer may file an amended Form 709 (United States Gift (and Generation-Skipping Transfer) Tax Return) or a supplemental Form 706 (United States Estate (and Generation-Skipping Transfer) Tax Return) to claim the marital deduction for a gift or bequest to the taxpayer's same-sex spouse and to restore the applicable exclusion amount allocated to that transfer so long as the limitations period for filing claims of credits or refunds under §6511 has not expired. (Notice 2017-15)

§2601 imposes a tax on each GST, which §2611(a) defines as a taxable distribution, a taxable termination, or a direct skip, all of which are transfers to or for the benefit of one or more "skip persons" (i.e., to a person who is considered to be of a generation two or more below that of the transferor or to certain trusts). (§2613(a)) A person's generation is determined based on the transferee's familial relationship to the transferor or the transferor's spouse, or if there is no such relationship, then based on the difference in age between the transferor and transferee. (§2651) Spouses are assigned to the same generation.

Under Regulation §26.2632-1(b)(4)(i), an allocation of GST exemption to a trust is void to the extent that the amount allocated exceeds the amount necessary to obtain an inclusion ratio of zero with respect to the trust. An allocation also is void if the allocation is made with respect to a trust that, at the time of the allocation, has no GST potential with respect to the transferor whose exemption was allocated.

Before the Windsor decision (below), IRS interpreted section 3 of the Defense of Marriage Act (DOMA), which prohibited the recognition of same-sex couples as spouses for purposes of federal law, as treating taxpayers in a same-sex marriage as unmarried for purposes of gift, estate, and GST taxes, and not allowing same-sex spouses to claim a marital deduction for gifts or bequests to each other. These taxpayers were required to use their applicable exclusion amount under §2505 or §2010(c) to defray any gift or estate tax imposed on the transfer, or were required to pay gift or estate taxes to the extent the taxpayer's exclusion previously had been exhausted. Further, taxpayers in a same-sex marriage were not allowed to determine generation assignments for GST tax purposes based on a familial relationship with the spouse, which meant that a same-sex spouse, or lineal descendant of that spouse, could potentially be treated as a "skip person" based solely on their age because the familial relationship was not recognized, and the transfer would require an allocation of the transferee's GST exemption or be subject to GST tax.

The Supreme Court declared Section 3 of DOMA unconstitutional on June 26, 2013 (Windsor, (Sup Ct) 111 AFTR 2d 2013-2385. Later that year, IRS issued Revenue Ruling 2013-17, 2013-38 IRB 201, which generally provides that a same-sex spouse will be treated as a spouse for federal tax purposes provided that the couple is lawfully married under state law. Revenue Ruling 2013-17 provided that its holdings would apply prospectively (i.e., as of September 16, 2013), and that taxpayers could rely on it to file original, amended, or adjusted returns, or credits for credits or refunds for any overpayment of tax resulting from its holdings, provided that such claims were not time-barred under §6511.

New guidance-applicable exclusion amount. With respect to the applicable exclusion amount applied to a transfer between spouses that, because of DOMA, did not qualify for the marital deduction for federal estate or gift tax purposes at the time of the transfer, taxpayers will be permitted to establish that transfer's qualification for the marital deduction and to recover the applicable exclusion amount previously applied on a return by reason of such a transfer, even if the limitations period applicable to that return for the assessment of tax or for claiming a credit or refund of tax under §6501 or §6511, respectively, has expired. If, however, qualification for the marital deduction or a reverse qualified terminable interest property (QTIP) election would require a QTIP, qualified domestic trust (QDOT), or reverse QTIP election, such taxpayers will have to request relief under Regulation §301.9100-3 to make such an election.

A taxpayer must recalculate the taxpayer's remaining applicable exclusion amount, in accordance with IRS forms and instructions, on a Form 709, on an amended Form 709 (if the limitations period under §6511 has not expired), or on the Form 706 for the taxpayer's estate if not reported on a Form

709. The taxpayer should include a statement at the top of the Form 706 or Form 709 that the return is "FILED PURSUANT TO NOTICE 2017-15," and attach a statement supporting the claim for the marital deduction and detailing the recalculation of the taxpayer's remaining applicable exclusion amount (as per instructions and a worksheet that IRS will provide on its website).

With respect to a taxpayer's GST exemption that was allocated to transfers made, prior to the recognition of same-sex marriages for federal tax purposes, to or for the benefit of one or more persons in a same-sex marriage and/or any other person(s) whose generation assignment is determined under §2651 with reference to a same-sex spouse, certain exemption allocations to transfers to persons now recognized to be non-skip persons as defined in §2613(b) will be deemed void. Accordingly, taxpayers who made such a transfer will be permitted to recalculate the amount of their remaining GST exemption.

A taxpayer must recalculate (also taking into account the GST implications of any interim transfers), in accordance with IRS forms and instructions, and report such taxpayer's available GST exemption based upon that recalculation, on a Form 709, on an amended Form 709 (if the limitations period under §6511 has not expired), or on the Form 706 for the taxpayer's estate if not reported on a Form 709. The taxpayer should include a statement at the top of the Form 706 or Form 709 that the return is "FILED PURSUANT TO NOTICE 2017-15" and should attach a statement that the taxpayer's allocation of GST exemption in a prior year is void and a copy of the computation of the resulting exemption allocation(s) and the amount of exemption remaining available to that taxpayer (as per instructions and a worksheet that IRS will provide on its website).

Notice 2017-12, 2017-4 IRB.

Following up on a posting to its webpage that was initially posted in December 2015, a Notice in which it announces that an IRS-issued account transcript can substitute for an estate tax closing letter.

An estate tax closing letter (IRS Letter 627) is a written communication from IRS that specifies the amount of the net estate tax, the state death tax credit or deduction, and any generation-skipping transfer tax for which the estate is liable.

The estate tax closing letter also confirms that the estate tax return has either been accepted by IRS as filed, or has been accepted after an adjustment by IRS to which the estate has agreed. Thus, the receipt of an estate tax closing letter generally indicates that, for purposes of determining the estate tax liability of the decedent's estate, the IRS examination of the estate tax return is closed.

An estate tax closing letter, however, is not a formal closing agreement and, as Revenue Procedure 2005-32, 2005-1 CB 1206, §5, and the estate tax closing letter provide, its issuance does not prevent IRS from reopening or reexamining the estate tax return to determine estate tax liability if there is (1) evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact; (2) a clearly-defined, substantial error based upon an established IRS position; or (3) another circumstance indicating that a failure to reopen the case would be a serious administrative omission. In addition, in the case of the estate of a decedent (survived by a spouse) that elects portability of the deceased spousal unused exclusion (DSUE) amount, the issuance of an estate tax closing letter does not prevent IRS from examining the estate tax return of that decedent for the purpose of determining the transfer tax liability of the surviving spouse of that decedent (specifically, the DSUE amount to be included in the applicable exclusion amount of the surviving spouse). (§2010(c)(5)(B); Regulation §20.2010-2(d); Regulation §20.2010-3(d))

Prior to June 1, 2015, IRS issued an estate tax closing letter for every estate tax return filed (except in the case of an estate tax return filed for the purpose of electing portability under §2010(c)(5)(A) when the estate had no filing requirement under §6018(a) and the portability election was denied). However, for estate tax returns filed on or after June 1, 2015, IRS changed its policy and issues an estate tax closing letter only at the request of an estate, which request is to be made at least four months after the filing of the estate tax return.

In December 2015, IRS posted a webpage entitled "Transcripts in Lieu of Estate Tax Closing Letters." On that page, it announced that account transcripts, which reflect transactions including the acceptance of Form 706 and the completion of an examination, may be an acceptable substitute for the estate tax closing letter.

IRS has now issued a Notice that announces that an IRS-issued account transcript can substitute for an estate tax closing letter. In so doing, IRS has updated some of the information on the Transcripts in Lieu of Estate Tax Closing Letters webpage.

IRS says that it understands that executors, local probate courts, state tax departments, and others have come to rely on estate tax closing letters for confirmation that the IRS examination of the estate tax return has been completed and the IRS file has been closed. Estate tax closing letters continue to be available upon request. However, an account transcript may substitute for an estate tax closing letter and is available at no charge.

An account transcript is a computer-generated report that provides current account data. The information reported on an account transcript includes, but is not limited to, the return received date, payment history, refund history, penalties assessed, interest assessed, the balance due with accruals, and the date on which the examination was closed.

For confirmation that IRS examination of an estate tax return has been completed and is closed, estates and their authorized representatives can request an account transcript in lieu of an estate tax closing letter. Receipt of an account transcript with a transaction code of "421," like receipt of an estate tax closing letter, confirms the closing of the IRS examination of the estate tax return. In other words, an account transcript showing a transaction code of "421" can serve as the functional equivalent of an estate tax closing letter.

IRS may reopen the examination of the estate tax return after the issuance of a closing letter or the entry of transaction code "421" on the account transcript for the purpose of determining the estate tax liability of a decedent in a circumstance described in both the closing letter and Revenue Procedure 2005-32. Further, as provided in §2010(c)(5)(B), Regulation §20.2010-2(d), and Regulation §20.2010-3(d), IRS may examine the estate tax return of a decedent after the issuance of a closing letter or the entry of transaction code "421" on the account transcript for the purpose of determining the transfer tax liability of the surviving spouse of that decedent when portability has been elected.

Estates and their authorized representatives may request an account transcript by filing Form 4506-T, Request for Transcript of Tax Return. Currently, Form 4506-T can be filed with IRS via mail or facsimile (per the instructions on the form). Although account transcripts for estate tax returns are not currently available through IRS's online Transcript Delivery System (TDS), the IRS website, www.irs.gov, will have current information should an automated method become operational. To allow time for processing the estate tax return, requests should be made no earlier than four months after filing the estate tax return.

IRS says that estates and their authorized representatives who wish to continue to receive estate tax closing letters may call IRS at (866) 699-4083 to request an estate tax closing letter no earlier than four months after the filing of the estate tax return.

Observation: As of September 24, 2017, IRS "Transcripts in Lieu of Estate Tax Closing Letters" is still available, at https://www.irs.gov/businesses/small-businesses-self-employed/transcripts-in-lieu-of-estate-tax-closing-letters. The web page was last updated August 8, 2017.

Notice 2017-1, 2017-2 IRB.

Expands the §7528(b)(2)(B) exemption from the requirement to pay a user fee for IRS determination letters regarding the qualified status of retirement plans maintained by small employers. IRS will treat an application for a determination letter as being filed within a qualifying open remedial amendment period if the plan was first in existence no earlier than January 1 of the 10th calendar year preceding the year in which the application is filed. Additionally, under certain circumstances, an application that satisfies the §7528(b)(2)(B) user fee exemption requirements, but does not meet the 10-year rule, may be filed without a user fee.

§7528 directs IRS to establish a program requiring the payment of a user fee for requests to IRS for ruling letters, opinion letters, determination letters, and other similar requests. §7528(b)(2)(A) provides an exemption from the user fee requirement as IRS deems appropriate.

§7528(b)(2)(B) provides that, in general, a request for a determination letter with respect to the qualified status of a pension benefit plan or any trust that is part of the plan is exempt from the user fee requirement if the plan is maintained solely by one or more "eligible employers" (one that has no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding year, and that has at least one employee who is not a highly compensated employee (as defined in §414(q)) and is participating in the plan). However, the §7528(b)(2)(B) user fee exemption does not apply if the request is made after the later of (1) the last day of the fifth plan year the plan is in existence, or (2) the end of any qualifying open remedial amendment period. The §7528(b)(2)(B) user fee exemption also does not apply to any request made by the sponsor of any prototype or similar plan that the sponsor intends to market to participating employers.

Revenue Procedure 2007-44, 2007-2 CB 54, provides for a system of cyclical remedial amendment periods and staggered submission periods for determination letter applications for individually designed plans and pre-approved plans. The remedial amendment cycle for individually designed plans is five years and the remedial amendment cycle for pre-approved plans is six years.

In Revenue Procedure 2016-37, 2016-29 IRB, IRS: (1) eliminated the remedial amendment cycle system for individually designed plans set forth in Revenue Procedure 2007-44, as of January 1, 2017; (2) provided that sponsors of Cycle A plans may continue to file under the remedial amendment cycle system until January 31, 2017; (3) made clarifying changes to the ongoing 6-year remedial amendment cycle system for pre-approved qualified plans; and (4) extended the deadline for certain employers to adopt a newly approved pre-approved defined contribution plan that was based on the 2010 Cumulative List, and to apply for a determination letter, from April 30, 2016, to April 30, 2017, for any newly approved pre-approved defined contribution plan adopted on or after January 1, 2016.

An application for a determination letter for a pension, profit-sharing, stock bonus, annuity, or employee stock ownership plan (ESOP) maintained by an eligible employer that is filed with IRS by the later of (1) the last day of the fifth plan year the plan is in existence, or (2) the end of any qualifying open remedial amendment period, is eligible for the §7528(b)(2)(B) user fee exemption, if the application satisfies all other applicable requirements for the exemption.

Under Notice 2017-1, to simplify the process for establishing whether the §7528(b)(2)(B) user fee exemption is available and, thus, whether a user fee must be paid with a determination letter application for a plan, IRS will, pursuant to its authority under §7528(b)(2)(A), treat an application as being filed within a qualifying open remedial amendment period (one of the requirements for the user fee exemption) if the plan was first in existence no earlier than January 1 of the 10th calendar year preceding the year in which the application is filed.

Illustration IRS will treat an application for a determination letter filed on December 1, 2017, for a plan that was first in existence during 2007, as having been filed within a qualifying open remedial amendment period for purposes of §7528(b)(2)(B). In contrast, if the plan had first been in existence during 2006, then IRS would not treat the application as being filed within a qualifying open remedial amendment period.

Additionally, under Notice 2017-1, no user fee is required if an application does not satisfy the requirements of the 10-year rule (and, accordingly, is not treated as being filed within a qualifying open remedial amendment period), but the application nevertheless satisfies the requirements for the user fee exemption under §7528(b)(2)(B) (for example, where a qualifying open remedial amendment period ends more than 10 years after the year in which the plan is first in existence). In such a case, instead of including a user fee with the application, the applicant should explain in a cover letter how the application satisfies the requirements for the §7528(b)(2)(B) exemption. If IRS determines that the application does not meet the user fee exemption requirements, the applicant will be asked to submit the required user fee.

Notice 2017-1, generally applies to all applications for determination letters that are filed on or after January 1, 2017. However, the rules under Notice 2011-86, 2011-45 IRB (which is obsoleted by the new Notice) continue to apply to (1) an application for a determination letter that is filed on or before January 31, 2017, under Cycle A with respect to an individually designed plan; and (2) an application for a determination letter that is filed on or before April 30, 2017, with respect to a newly approved pre-approved defined contribution plan that is based on the 2010 Cumulative List and adopted on or after January 1, 2016.

Notice 2016-80, 2016-52 IRB.

2016 Required Amendments List (RA List) for individually-designed qualified retirement plans. The list identifies certain changes in qualification requirements that became effective in 2016 that may require a retirement plan to be amended in order to remain qualified, and establishes the date by which any necessary amendment must be made.

§401(b) provides a remedial amendment period during which a plan may be amended retroactively to comply with the Code's qualification requirements. The disqualifying provisions that may be amended retroactively, and the remedial amendment period during which retroactive amendments may be adopted, are described in Regulation §1.401(b)-1.

In June of this year, IRS issued Revenue Procedure 2016-37, 2016-29 IRB 136, which modifies IRS's determination letter program for qualified plans to eliminate, as of January 1, 2017, the 5-year remedial amendment cycle system for individually designed plans. (Revenue Procedure 2016-37, §4.02) Effective January 1, 2017, a sponsor of an individually designed plan will be permitted to submit a determination letter application only for initial plan qualification, for qualification upon plan termination, and in certain other circumstances.

With respect to individually designed plans, Revenue Procedure 2016-37, §5 extends the remedial amendment period to correct disqualifying provisions that arise as a result of a change in qualification requirements, to be the end of the second calendar year that begins after the issuance of the RA List on which the change in qualification requirements appears. For governmental plans, an additional extension may be available. Revenue Procedure 2016-37, §8 provides that the plan amendment deadline with respect to a disqualifying provision described in Revenue Procedure 2016-37, §5 is the date on which the remedial amendment period ends with respect to that disqualifying provision.

IRS also stated in Revenue Procedure 2016-37, §9 that it intends to annually publish an RA List of statutory and administrative changes in qualification requirements that are first effective during the plan year in which the list is published. In general, a change in qualification requirements will not appear on an RA List until guidance with respect to that change has been provided in regulations or in other published guidance. However, IRS has the discretion to include a change in qualification requirements in other circumstances, such as when a statutory change is enacted and IRS anticipates that no guidance will be issued.

An RA list does not include: statutory changes in qualification requirements for which IRS expects to issue guidance (which would be included on an RA list issued in a future year); changes in qualification requirements that permit (but do not require) optional plan provisions; or changes in the tax laws affecting qualified plans that do not change the qualification requirements under §401(a) (e.g., changes to the tax treatment of plan distributions).

An RA List is divided into two parts. Part A covers changes in qualification requirements that generally would require an amendment to most plans or to most plans of the type affected by the change. However, the fact that a change in a qualification requirement is included on an RA list does not mean that a plan must be amended as a result of that change; rather, each plan sponsor must determine whether a particular change requires an amendment. Part B includes changes in qualification requirements that IRS anticipates will not require amendments in most plans, but might require an amendment because of an unusual plan provision in a particular plan. If a change affects a particular qualification requirement that most plans incorporate by reference, Part B would include the change because a particular plan might not incorporate the qualification requirement by reference and thus, might contain language inconsistent with the change. (Notice 2016-80, §III)

Annual, monthly, or other periodic changes to the various dollar limits that are adjusted for cost of living increases, the spot segment rates used to determine the applicable interest rate under §417(e)(3), and the applicable mortality table under §417(e)(3), are treated as included on the RA List for the year in which such changes are effective even though they are not directly referenced on such RA List. (Notice 2016-80, §III)

For 2016, there were no required amendments shown for Part A.

For Part B, there was one change in qualification requirements that may require an amendment for collectively-bargained defined benefit plans: restrictions on accelerated distributions from underfunded single-employer plans in employer bankruptcy under §436. (*Highway and Transportation Funding Act of 2014,* P.L. 113-159, §2003) (Notice 2016-80, §IV)

December 31, 2018 is the last day of the remedial amendment period, and thus the plan amendment deadline, with respect to a disqualifying provision arising as a result of a change in qualification requirements appearing on the 2016 RA List. However, as described above, a later date may apply to a governmental plan. (Notice 2016-80, §I)

Hurricane Irma – More Tax Relief

Victims of Hurricane Irma have more time to make tax payments and file returns if they are affected taxpayers qualifying for individual assistance in designated federal disaster areas. Certain other time-sensitive acts also are postponed. IRS has recently announced on its website that an additional island in U.S. Virgin Islands has been designated as federal disaster areas qualifying for individual assistance. This article summarizes the relief that's available and includes up-to-date disaster area designations and extended filing and deposit dates for all areas affected by storms, floods and other disasters in 2017.

Only taxpayers considered to be affected taxpayers are eligible for the postponement of time to file returns, pay taxes and perform other time-sensitive acts. Affected taxpayers are those listed in Regulation §301.7508A-1(d)(1) and thus include:

1. Any individual whose principal residence, and any business entity whose principal place of business, is located in the counties designated as disaster areas;

2. Any individual who is a relief worker assisting in a covered disaster area, regardless of whether he is affiliated with recognized government or philanthropic organizations;

3. Any individual whose principal residence, and any business entity whose principal place of business, is not located in a covered disaster area, but whose records necessary to meet a filing or payment deadline are maintained in a covered disaster area;

4. Any estate or trust that has tax records necessary to meet a filing or payment deadline in a covered disaster area; and

5. Any spouse of an affected taxpayer, solely with regard to a joint return of the husband and wife.

Under §7508A, IRS gives affected taxpayers until the extended date (specified by county, below) to file most tax returns (including individual, estate, trust, partnership, C corporation, and S corporation income tax returns; estate, gift, and generation-skipping transfer tax returns; and employment and certain excise tax returns), or to make tax payments, including estimated tax payments, that have either an original or extended due date falling on or after the onset date of the disaster (specified by county, below), and on or before the extended date.

IRS also gives affected taxpayers until the extended date to perform other time-sensitive actions described in Regulation §301.7508A-1(c)(1) and Revenue Procedure 2007-56, 2007-34 IRB 388, that are due to be performed on or after the onset date of the disaster, and on or before the extended date. This relief also includes the filing of Form 5500 series returns, in the way described in Revenue Procedure 2007-56, §8. Additionally, the relief described in Revenue Procedure 2007-56, §17, relating to like-kind exchanges of property, also applies to certain taxpayers who are not otherwise affected taxpayers and may include acts required to be performed before or after the period above.

The postponement of time to file and pay does not apply to information returns in the W-2, 1098, 1099 or 5498 series, or to Forms 1042-S or 8027. Penalties for failure to timely file information returns can be waived under existing procedures for reasonable cause. Likewise, the postponement does not apply to employment and excise tax deposits. IRS, however, will abate penalties for failure to make timely employment and excise deposits, due on or after the onset date of the disaster, and on or before the deposit delayed date (specified by county, below), provided the taxpayer made these deposits by the deposit delayed date.

Affected areas and dates for storms, floods and other disasters occurring in 2017 that are federal disaster areas qualifying for individual assistance, as published on IRS's website, are carried below.

Observation: Effective for disasters declared in tax years beginning after December 31, 2007, the term “federally declared disaster” replaced the previously used “presidential disaster area” term (see §1033(h)(3), as amended by §706(d)(1), Div. C, P.L. 110-343). The new term is substantially the same as the definition of “presidentially declared disaster” under former law.

Arkansas: The following are federal disaster areas qualifying for individual assistance on account of severe storms, tornadoes, straight-line winds and flooding that took place beginning on April 26, 2017: Benton, Boone, Carroll, Clay, Faulkner, Fulton, Jackson, Lawrence, Pulaski, Randolph, Prairie, Saline, White, Woodruff, Washington, and Yell counties.

For these Arkansas counties, the onset date of the disaster was April 26, 2017 and the extended date was August 31, 2017 (which includes the estimated tax payment due on June 15, 2017 and the quarterly payroll tax returns due on May 1, 2017 and July 31, 2017). The deposit delayed date was May 11, 2017.

Florida: The following are federal disaster areas qualifying for individual assistance on account of Hurricane Irma that took place beginning on September 4, 2017: Alachua, Baker, Bay, Bradford, Brevard, Broward, Calhoun, Charlotte, Citrus, Clay, Collier, Columbia, DeSoto, Dixie, Duval, Escambia, Flagler, Franklin, Gadsden, Gilchrist, Glades, Gulf, Hamilton, Hardee, Hendry, Hernando, Highlands, Hillsborough, Holmes, Indian River, Jackson, Jefferson, Lafayette, Lake, Lee, Leon, Levy, Liberty, Madison, Manatee, Marion, Martin, Miami-Dade, Monroe, Nassau, Okaloosa, Okeechobee, Orange, Osceola, Palm Beach, Pasco, Pinellas, Polk, Putnam, Santa Rosa, Sarasota, Seminole, St. Johns, St. Lucie, Sumter, Suwannee, Taylor, Union, Volusia, Wakulla, Walton, Washington counties.

For these Florida counties, the onset date of the disaster was September 4, 2017 and the extended date is January 31, 2018 (which includes 2016 income tax returns for which taxpayers obtained a valid extension to file by October 16, 2017; the quarterly estimated income tax payments originally due on September 15, 2017 and January 16, 2018; the quarterly payroll and excise tax returns normally due on October 31, 2017; and returns of tax-exempt organizations that operate on a calendar-year basis and had an automatic extension due to run out on Nov. 15, 2017). The deposit delayed date was September 19, 2017. (IR 2017-155)

Georgia: The following is a federal disaster area qualifying for individual assistance on account of severe storms, tornadoes, and straight-line winds that took place beginning on January 2, 2017: Dougherty County.

For this Georgia County, the onset date of the disaster was January 2, 2017 and the extended date was May 31, 2017 (which includes 2016 income tax returns normally due on April 18, and the January 15 and April 18 deadlines for making quarterly estimated tax payments). The deposit delayed date was January 17, 2017.

Georgia: The following are federal disaster areas qualifying for individual assistance on account of severe storms, tornadoes, and straight-line winds that took place beginning on January 21, 2017: Berrien, Cook, Crisp, Dougherty, Thomas, Turner, Worth, and Wilcox counties.

For these Georgia counties, the onset date of the disaster was January 21, 2017 and the extended date was May 31, 2017 (which includes 2016 income tax returns normally due on April 18 and the April 18 deadlines for making quarterly estimated tax payments). The deposit delayed date was February 6, 2017.

Georgia: Following the President's declaration that a major disaster exists in the state of Georgia, IRS announced that affected taxpayers in the entire state (all 159 counties) will receive tax relief on account of Hurricane Irma, which took place beginning on September 7, 2017.

For the entire state of Georgia, the onset date of the disaster was September 7, 2017 and the extended date is January 31, 2018 (which includes 2016 income tax returns for which taxpayers obtained a valid extension to file by October 16, 2017; the quarterly estimated income tax payments originally due on September 15, 2017 and January 16, 2018; and the quarterly payroll and excise tax returns normally due on October 31, 2017; and the tax-exempt organizations that operate on a calendar-year basis and had an automatic extension due to run out on Nov. 15, 2017). The deposit delayed date is September 22, 2017. (IR 2017-156)

Louisiana: The following are federal disaster areas qualifying for individual assistance on account of severe storms, tornadoes, and straight-line winds that took place beginning on February 7, 2017: Livingston and Orleans parishes.

For these Louisiana parishes, the onset date of the disaster was February 7, 2017, and the extended date was June 30, 2017 (which includes the 2016 income tax returns normally due on April 18 and the April 18 deadlines for making quarterly estimated tax payments). The deposit delayed date was February 22, 2017.

Michigan: The following are federal disaster areas qualifying for individual assistance on account of severe storms and flooding that took place beginning on June 22, 2017: Bay, Gladwin, Isabella, and Midland counties, and the Saginaw Chippewa Tribe within Isabella County.

For these Michigan counties, the onset date of the disaster was June 22, 2017, and the extended date is October 31, 2017 (which includes the 2016 income tax returns for which taxpayers obtained a valid extension to file by October 16, 2017; the September 15, 2017 deadline for making quarterly estimated tax payments; and the quarterly payroll tax return due on July 31, 2017). The deposit delayed date was July 7, 2017.

Mississippi: The following are federal disaster areas qualifying for individual assistance on account of severe storms, tornadoes, and straight-line winds that took place beginning on January 20, 2017: Forrest, Lamar, Lauderdale, and Perry counties.

For these Mississippi counties, the onset date of the disaster was January 20, 2017, and the extended date was May 31, 2017 (which includes the 2016 income tax returns normally due on April 18; the April 18 deadlines for making quarterly estimated tax payments; and the estimated income tax payment originally due on or after January 20, 2017, and before May 31, 2017). The deposit delayed date was February 6, 2017.

Missouri: The following are federal disaster areas qualifying for individual assistance on account of severe storms, tornadoes, straight-line winds, and flooding that took place beginning on April 28, 2017: Bollinger, Butler, Carter, Christian, Crawford, Dent, Douglas, Dunklin, Franklin, Gasconade, Greene, Howell, Jasper, Jefferson, Madison, Maries, McDonald, Newton, Oregon, Osage, Ozark, Pemiscot, Phelps, Pulaski, Reynolds, Ripley, Shannon, St. Louis, Ste. Genevieve, Stone, Taney, Texas, Wayne, and Wright counties.

For these Missouri counties, the onset date of the disaster was April 28, 2017, and the extended date was August 31, 2017 (which includes the estimated tax payment due on June 15, 2017 and the quarterly payroll tax returns due on April 30, 2017 and July 31, 2017). The deposit delayed date was May 15, 2017.

Puerto Rico: The following are federal disaster areas qualifying for individual assistance on account of Hurricane Irma that took place beginning on September 5, 2017: Adjuntas, Aguas Buenas, Barranquitas, Bayamón, Camuy, Canóvanas, Carolina, Cataño, Ciales, Comerío, Culebra, Guaynabo, Hatillo, Jayuya, Juncos, Las Piedras, Loiza, Luquillo, Orocovis, Patillas, Quebradillas, Salinas, San Juan, Utuado, Vega Baja, Vieques, and Yauco municipalities.

For these Puerto Rico municipalities, the onset date of the disaster was September 5, 2017, and the extended date is January 31, 2018 (which includes 2016 income tax returns for which taxpayers obtained a valid extension to file by October 16, 2017; the quarterly estimated income tax payments originally due on September 15, 2017 and January 16, 2018; the quarterly payroll and excise tax returns normally due on October 31, 2017; and returns of tax-exempt organizations that operate on a calendar-year basis and had an automatic extension due to run out on Nov. 15, 2017). The deposit delayed date was September 20, 2017.

Texas: The following are federal disaster areas qualifying for individual assistance on account of Hurricane Harvey that took place beginning on August 23, 2017: Aransas, Austin, Batrop, Bee, Brazoria, Calhoun, Chambers, Colorado, DeWitt, Fayette, Fort Bend, Galveston, Goliad, Gonzales, Hardin, Harris, Jackson, Jasper, Jefferson, Karnes, Kleberg, Lavaca, Lee, Liberty, Matagorda, Montgomery, Newton, Nueces, Orange, Polk, Refugio, Sabine, San Jacinto, San Patricio, Tyler, Victoria, Walker, Wharton, and Waller counties.

For these Texas counties, the onset date of the disaster was August 23, 2017, and the extended date is January 31, 2018 (including the September 15, 2017 and January 16, 2018 deadlines for making quarterly estimated tax payments, 2016 individual income tax returns for which taxpayers received a tax-filing extension until October 16, 2017, the October 31, 2017 deadline for quarterly payroll and excise tax returns, and returns of tax-exempt organizations with an original or extended filing deadline falling within the period beginning on August 23, 2017, and ending on January 31, 2018). The deposit delayed date was September 7, 2017.

U.S. Virgin Islands: The following are federal disaster areas qualifying for individual assistance on account of Hurricane Irma that took place beginning on September 5, 2017: St. Croix, St. John, and St. Thomas islands.

For these areas of the U.S. Virgin Islands, the onset date of the disaster was September 5, 2017, and the extended date is January 31, 2018 (which includes 2016 income tax returns for which taxpayers obtained a valid extension to file by October 16, 2017; the quarterly estimated income tax payments originally due on September 15, 2017 and January 16, 2018; the quarterly payroll and excise tax returns normally due on October 31, 2017; and returns of tax-exempt organizations that operate on a calendar-year basis and had an automatic extension due to run out on Nov. 15, 2017). The deposit delayed date was September 20, 2017.

West Virginia: The following are federal disaster areas qualifying for individual assistance on account of severe storms, flooding, landslides, and mudslides that took place beginning on July 28, 2017: Harrison, Marion, Marshall, and Wetzel counties.

For these West Virginia counties, the onset date of the disaster was July 28, 2017, and the extended date is Nov. 30, 2017 (which includes 2016 income tax returns for which taxpayers obtained a valid extension to file by October 16, 2017; the September 15, 2017 deadline for making quarterly estimated tax payments; and the quarterly payroll and excise tax returns normally due on July 31, 2017 and October 31, 2017). The deposit delayed date was August 14, 2017.

IR-2017-150 IRS Announces Hurricane Irma Relief

Hurricane Irma victims in parts of Florida, the U.S. Virgin Island and Puerto Rico have until January 31, 2018, to file certain individual and business tax returns and make certain tax payments.
So far, the IRS filing and payment relief applies to the following localities identified by FEMA for Individual Assistance due to Hurricane Irma:

Florida: Broward, Charlotte, Clay, Collier, Duval, Flagler, Hillsborough, Lee, Manatee, Miami-Dade, Monroe, Palm Beach, Pinellas, Putnam, Sarasota and St. Johns Counties.

U.S. Virgin Islands: The islands of St. John and St. Thomas.

Puerto Rico: The municipalities of Culebra and Vieques.

The relief is the same as that granted last month to victims of Hurricane Harvey. This includes an additional filing extension for taxpayers with valid extensions that expire October 16, 2017, and businesses with extensions that expire on September 15, 2017.

The tax relief postpones various tax filing and payment deadlines that occurred starting on September 4, 2017 in Florida and September 5, 2017 in Puerto Rico and the Virgin Islands. As a result, affected individuals and businesses will have until January 31, 2018, to file returns and pay any taxes that were originally due during this period.

This includes the September 15, 2017 and January 16, 2018 deadlines for making quarterly estimated tax payments. For individual tax filers, it also includes 2016 income tax returns that received a tax-filing extension until October 16, 2017. The IRS noted, however, that because tax payments related to these 2016 returns were originally due on April 18, 2017, those payments are not eligible for this relief.

A variety of business tax deadlines are also affected including the October 31, 2017 deadline for quarterly payroll and excise tax returns. Businesses with extensions also have the additional time including, among others, calendar-year partnerships whose 2016 extensions run out on September 15, 2017 and calendar-year tax-exempt organizations whose 2016 extensions run out on November 15, 2017. The disaster relief page has details on other returns, payments and tax-related actions qualifying for the additional time.

In addition, the IRS is waiving late-deposit penalties for federal payroll and excise tax deposits normally due during the first 15 days of the disaster period. Check out the disaster relief page for the time periods that apply to each jurisdiction.

The IRS automatically provides filing and penalty relief to any taxpayer with an IRS address of record located in the disaster area. Thus, taxpayers need not contact the IRS to get this relief. However, if an affected taxpayer receives a late filing or late payment penalty notice from the IRS that has an original or extended filing, payment or deposit due date falling within the postponement period, the taxpayer should call the number on the notice to have the penalty abated. In addition, the IRS will work with any taxpayer who lives outside the disaster area but whose records necessary to meet a deadline occurring during the postponement period are located in the affected area. Taxpayers qualifying for relief who live outside the disaster area need to contact the IRS at 866-562-5227. This also includes workers assisting the relief activities who are affiliated with a recognized government or philanthropic organization.

Individuals and businesses who suffered uninsured or unreimbursed disaster-related losses can choose to claim them on either the return for the year the loss occurred (in this instance, the 2017 return normally filed next year), or the return for the prior year (2016).

For individuals, losses of property not connected with a trade or business or a transaction entered into for profit are deductible as personal casualty losses if the losses are the result of fire, storm, shipwreck, or other casualty.

Ordinarily, to figure a deduction for a casualty or theft loss of personal-use property, taxpayers must reduce the loss by $100 and also reduce their total casualty and theft losses by 10 percent of their adjusted gross income. Only the excess over these $100 and 10 percent limits is deductible. Previous legislation has removed these limits for Hurricane Katrina, Rita and Wilma so that the entire amount of these unreimbursed losses is deductible. It is uncertain whether Congress will pass similar relief for Irma.

A taxpayer claims a casualty loss deduction for personal-use property by reporting the amount of the loss on Form 4684, Casualties and Thefts, and claiming an itemized deduction on Schedule A, Itemized Deductions, of the taxpayer's return.

A taxpayer claims a casualty loss deduction for business or income-producing property on Section B of Form 4684, and on Form 4797, Sales of Business Property, if required.

A casualty loss deduction may be claimed on an original return or a timely-filed amended return. The manner for determining the amount of a casualty loss allowable as a deduction in computing taxable income is the same whether the loss has been incurred in a trade or business and not incurred in any transaction entered into for profit.

A taxpayer who suffers a loss occurring in a disaster area that's attributable to a federally declared disaster can take the deduction in the tax year in which the disaster occurs, or can elect to deduct the loss in the tax year immediately preceding the tax year in which the disaster occurs.

As with all casualty (or theft) losses, disaster losses must be claimed as an itemized deduction. Taxpayers who take the standard deduction cannot claim them.

For more information, see https://www.irs.gov/newsroom/help-for-victims-of-hurricane-irma
https://www.fema.gov/

Announcement 2017-13, 2017-40 IRB; IR 2017-1 51

IRS has announced that employer-sponsored retirement plans can make loans and hardship distributions to victims of Hurricane Irma and members of their families. And, while IRA participants are barred from taking out loans, they may be eligible to receive distributions under liberalized procedures. But, IRS is not waiving the 10% penalty that applies to early withdrawals.

The laws relating to qualified employer plans impose various limitations on the permissibility of loans and distributions from those plans. For example, §401(k)(2)(B)(i) provides that in the case of a §401(k) plan that is part of a profit-sharing or stock bonus plan, elective deferrals may be distributed only in certain situations, one of which is on account of hardship. §403(b)(11) provides similar rules with respect to elective deferrals under a §403(b) plan. §457(d)(1)(A) provides that a plan described in §457(b) may not permit distributions before the occurrence of certain enumerated events, one being when the participant is faced with an unforeseeable emergency.

Certain other types of plans or accounts are not permitted to make in-service distributions (i.e., distributions to a participant who is still an employee) even if there is a hardship. For example, in-service hardship distributions are generally not permitted from pension plans or from accounts holding qualified nonelective contributions (QNECs) described in §401(m)(4)(C) or qualified matching contributions (QMACs) described in §401(k)(3)(D)(ii)(I). However, Rev Rul 2004-12, 2004-2 CB 478, holds that if amounts attributable to rollover contributions are separately accounted for within a plan, those amounts may be distributed at any time, pursuant to the employee's request.

In order to make a loan or distribution (including a hardship distribution), a plan must contain language authorizing the loan or distribution.

A loan from a qualified employer plan to a participant or beneficiary is treated as a plan distribution unless:

1. The loan amount does not exceed the lesser of: (i) $50,000, or (ii) ½ of the present value of the employee's nonforfeitable accrued benefit under the plan. However, a loan up to $10,000 is allowed, even if it's more than half the employee's accrued benefit. (§72(p)(2)(A))

2. The loan is required to be repaid within five years, (§72(p)(2)(B)(i)) except that a longer repayment can be used for a principal residence plan loan, i.e., a loan used to acquire any dwelling unit which, within a reasonable time, is to be used as the participant's principal residence; (§72(p)(2)(B)(ii))

3. Except as provided in the regulations, the plan loan is amortized in substantially level payments, made not less frequently than quarterly; and (§72(p)(2)(C))

4. The loan must be evidenced by a legally enforceable agreement. (Regulation §1.72(p)-1, Q&A 3)

Early (generally, pre-age 59.5) withdrawals from a qualified retirement plan result in an additional tax equal to 10% of the amounts withdrawn that are includible in gross income. (§72(t)(1)) The additional tax applies unless the taxpayer qualifies for one of several specific exceptions. (§72(t)(2), §72(t)(3)) There is no exception for hardship withdrawals. A similar rule applies to distributions from an IRA. Plan provisions and regulations under certain Code sections establish verification procedures that a plan must follow before loans or distributions can be made from the plan. For example, the regulations under §401(k) set forth certain criteria an employee must meet in order to receive a hardship distribution. A plan may contain procedures designed to confirm that the criteria have been satisfied.

IRS provides relief. IRS has now provided various types of relief with respect to retirement plan distributions and loans.

Observation: Except with respect to certain dates, the relief provided to Hurricane Irma victims, and the rules for obtaining the relief, are the same as those that apply to Hurricane Harvey.

A qualified employer plan will not be treated as failing to satisfy any requirement under the Code or regulations merely because the plan makes a loan or a hardship distribution, for a need arising from Hurricane Irma, to an employee or former employee whose principal residence on September 4, 2017, was located in one of the Florida counties identified for individual assistance by the Federal Emergency Management Agency (FEMA) because of the devastation caused by Hurricane Irma. That same rule also applies to persons whose place of employment was located in one of these counties on that date or whose lineal ascendant or descendant, dependent, or spouse had a principal residence or place of employment in one of these counties on that date.

The counties identified for individual assistance by FEMA can be found on FEMA's website at https://www.fema.gov/disasters.

If additional areas are identified by FEMA for individual assistance because of damage related to Hurricane Irma, the relief provided in the Announcement will also apply, from the date specified by FEMA as the beginning of the incident period, and that date should be substituted for references to September 4, 2017, in the Announcement. Plan administrators may rely upon representations from the employee or former employee as to the need for and amount of a hardship distribution, unless the plan administrator has actual knowledge to the contrary. The distributions will be treated as hardship distributions for all purposes under the Code and regulations.

For purposes of the Announcement, a "qualified employer plan" means a plan or contract meeting the requirements of §401(a), §403(a) or §403(b), and, for purposes of the hardship relief, such a plan that could, if it contained enabling language, make hardship distributions. For purposes of this paragraph, a "qualified employer plan" also means a plan described in §457(b) maintained by an eligible employer described in §457(e)(1)(A), and any hardship arising from Hurricane Irma is treated as an "unforeseeable emergency" for purposes of distributions from such plans. For example, a profit-sharing or stock bonus plan that currently does not provide for hardship or other in-service distributions may nevertheless make hardship distributions related to Hurricane Irma pursuant to the Announcement, except from QNEC or QMAC accounts or from earnings on elective contributions. A defined benefit or money purchase plan, which generally cannot make in-service hardship distributions, may not make hardship distributions pursuant to the Announcement, other than from a separate account, if any, within the plan containing either employee contributions or rollover amounts.

The amount available for hardship distribution is limited to the maximum amount that would be permitted to be available for a hardship distribution under the plan under the Code and regulations. However, the relief provided by the Announcement applies to any hardship of the employee, not just the types enumerated in the regulations, and no post-distribution contribution restrictions are required. For example, regulations under §401(k) provide safe harbor hardship distribution standards under which a hardship is deemed to exist only for certain enumerated events, and, after receipt of the hardship amount, the employee is prohibited from making contributions for at least six months. Plans need not follow these rules with respect to hardship distributions for which relief is provided under the Announcement.

To make a loan or hardship distribution pursuant to the relief provided in the Announcement, a qualified employer plan that does not provide for them must be amended to provide for loans or hardship distributions no later than the end of the first plan year beginning after December 31, 2017. To qualify for the relief under the Announcement, a hardship distribution must be made on account of a hardship resulting from Hurricane Irma and be made on or after September 4, 2017, and no later than January 31, 2018. Plan loans made pursuant to the Announcement must satisfy the requirements of §72(p).

In addition, a retirement plan will not be treated as failing to follow procedural requirements for plan loans (in the case of retirement plans other than IRAs) or distributions (in the case of all retirement plans, including IRAs) imposed by the terms of the plan merely because those requirements are disregarded for any period beginning on or after September 4, 2017, and continuing through January 31, 2018, with respect to loans or distributions to individuals described in the above paragraph that begins "As described below," provided the plan administrator (or financial institution in the case of distributions from IRAs) makes a good-faith diligent effort under the circumstances to comply with those requirements.

However, as soon as practicable, the plan administrator (or financial institution in the case of IRAs) must make a reasonable attempt to assemble any forgone documentation. For example, if spousal consent is required for a plan loan or distribution and the plan terms require production of a death certificate if the employee claims his or her spouse is deceased, the plan will not be disqualified for failure to operate in accordance with its terms if it makes a loan or distribution to an individual described in the above "As described below" paragraph in the absence of a death certificate if it is reasonable to believe, under the circumstances, that the spouse is deceased, the loan or distribution is made no later than January 31, 2018, and the plan administrator makes reasonable efforts to obtain the death certificate as soon as practicable.

For purposes of the Announcement, "retirement plan" has the same meaning as "eligible retirement plan" under §402(c)(8)(B).

In general, the normal spousal consent rules continue to apply, and, except to the extent the distribution consists of already-taxed amounts, any distribution made pursuant to the relief provided in the Announcement will be includible in gross income and generally subject to the 10% additional tax under §72(t).

IRS notes that the relief that it is currently providing is similar to the relief provided last year to Louisiana flood victims and victims of Hurricane Matthew.

The Department of Labor has said that it will not treat any person as having violated the provisions of Title I of the Employee Retirement Income Security Act solely because that person complied with the provisions of the Announcement.

Announcement 2017-11, 2017-39 IRB; IR 2017-138.

Employer-sponsored retirement plans can make loans and hardship distributions to victims of Hurricane Harvey and members of their families. And, while IRA participants are barred from taking out loans, they may be eligible to receive distributions under liberalized procedures. But, IRS is not waiving the 10% penalty that applies to early withdrawals.

The laws relating to qualified employer plans impose various limitations on the permissibility of loans and distributions from those plans. For example, §401(k)(2)(B)(i) provides that in the case of a §401(k) plan that is part of a profit-sharing or stock bonus plan, elective deferrals may be distributed only in certain situations, one of which is on account of hardship. §403(b)(11) provides similar rules with respect to elective deferrals under a §403(b) plan. §457(d)(1)(A) provides that a plan described in §457(b) may not permit distributions before the occurrence of certain enumerated events, one being when the participant is faced with an unforeseeable emergency.

Certain other types of plans or accounts are not permitted to make in-service distributions (i.e., distributions to a participant who is still an employee) even if there is a hardship. For example, in-service hardship distributions are generally not permitted from pension plans or from accounts holding qualified nonelective contributions (QNECs) described in §401(m)(4)(C) or qualified matching contributions (QMACs) described in §401(k)(3)(D)(ii)(I). However, Revenue Ruling 2004-12, 2004-2 CB 478, holds that if amounts attributable to rollover contributions are separately accounted for within a plan, those amounts may be distributed at any time, pursuant to the employee's request.

In order to make a loan or distribution (including a hardship distribution), a plan must contain language authorizing the loan or distribution.

A loan from a qualified employer plan to a participant or beneficiary is treated as a plan distribution unless:

1. The loan amount does not exceed the lesser of: (i) $50,000, or (ii) ½ of the present value of the employee's nonforfeitable accrued benefit under the plan. However, a loan up to $10,000 is allowed, even if it's more than half the employee's accrued benefit. (§72(p)(2)(A))

2. The loan is required to be repaid within five years, (§72(p)(2)(B)(i)) except that a longer repayment can be used for a principal residence plan loan, i.e., a loan used to acquire any dwelling unit which, within a reasonable time, is to be used as the participant's principal residence; (§72(p)(2)(B)(ii))

3. Except as provided in the regulations, the plan loan is amortized in substantially level payments, made not less frequently than quarterly; and (§72(p)(2)(C))

4. The loan must be evidenced by a legally enforceable agreement. (Regulation §1.72(p)-1, Q&A 3)

Early (generally, pre-age 59.5) withdrawals from a qualified retirement plan result in an additional tax equal to 10% of the amounts withdrawn that are includible in gross income. (§72(t)(1)) The additional tax applies unless the taxpayer qualifies for one of several specific exceptions. (§72(t)(2), §72(t)(3)) There is no exception for hardship withdrawals. A similar rule applies to distributions from an IRA.

Plan provisions and regulations under certain Code sections establish verification procedures that a plan must follow before loans or distributions can be made from the plan. For example, the regulations under §401(k) set forth certain criteria an employee must meet in order to receive a hardship distribution. A plan may contain procedures designed to confirm that the criteria have been satisfied.

IRS has now provided various types of relief with respect to retirement plan distributions and loans.

As described below, a qualified employer plan will not be treated as failing to satisfy any requirement under the Code or regulations merely because the plan makes a loan or a hardship distribution, for a need arising from Hurricane Harvey, to an employee or former employee whose principal residence on August 23, 2017, was located in one of the Texas counties identified for individual assistance by the Federal Emergency Management Agency (FEMA) because of the devastation caused by Hurricane Harvey. That same rule also applies to persons whose place of employment was located in one of these counties on that date or whose lineal ascendant or descendant, dependent, or spouse had a principal residence or place of employment in one of these counties on that date.

The counties identified for individual assistance by FEMA can be found on FEMA's website at https://www.fema.gov/disasters. If additional areas in Texas or other states are identified by FEMA for individual assistance because of damage related to Hurricane Harvey, the relief provided in the Announcement will also apply, from the date specified by FEMA as the beginning of the incident period, and that date should be substituted for references to August 23, 2017, in the Announcement. Plan administrators may rely upon representations from the employee or former employee as to the need for and amount of a hardship distribution, unless the plan administrator has actual knowledge to the contrary. The distributions will be treated as hardship distributions for all purposes under the Code and regulations.

For purposes of the Announcement, a "qualified employer plan" means a plan or contract meeting the requirements of §401(a), §403(a) or §403(b), and, for purposes of the hardship relief, such a plan that could, if it contained enabling language, make hardship distributions. For purposes of this paragraph, a "qualified employer plan" also means a plan described in §457(b) maintained by an eligible employer described in §457(e)(1)(A), and any hardship arising from Hurricane Harvey is treated as an "unforeseeable emergency" for purposes of distributions from such plans. For example, a profit-sharing or stock bonus plan that currently does not provide for hardship or other in-service distributions may nevertheless make hardship distributions related to Hurricane Harvey pursuant to the Announcement, except from QNEC or QMAC accounts or from earnings on elective contributions. A defined benefit or money purchase plan, which generally cannot make in-service hardship distributions, may not make hardship distributions pursuant to the Announcement, other than from a separate account, if any, within the plan containing either employee contributions or rollover amounts.

The amount available for hardship distribution is limited to the maximum amount that would be permitted to be available for a hardship distribution under the plan under the Code and regulations. However, the relief provided by the Announcement applies to any hardship of the employee, not just the types enumerated in the regulations, and no post-distribution contribution restrictions are required. For example, regulations under §401(k) provide safe harbor hardship distribution standards under which a hardship is deemed to exist only for certain enumerated events, and, after receipt of the hardship amount, the employee is prohibited from making contributions for at least six months. Plans need not follow these rules with respect to hardship distributions for which relief is provided under the Announcement.

To make a loan or hardship distribution pursuant to the relief provided in the Announcement, a qualified employer plan that does not provide for them must be amended to provide for loans or hardship distributions no later than the end of the first plan year beginning after December 31, 2017. To qualify for the relief under the Announcement, a hardship distribution must be made on account of a hardship resulting from Hurricane Harvey and be made on or after August 23, 2017, and no later than January 31, 2018. Plan loans made pursuant to the Announcement must satisfy the requirements of §72(p).

In addition, a retirement plan will not be treated as failing to follow procedural requirements for plan loans (in the case of retirement plans other than IRAs) or distributions (in the case of all retirement plans, including IRAs) imposed by the terms of the plan merely because those requirements are disregarded for any period beginning on or after August 23, 2017, and continuing through January 31, 2018, with respect to loans or distributions to individuals described in the above paragraph that begins "As described below," provided the plan administrator (or financial institution in the case of distributions from IRAs) makes a good-faith diligent effort under the circumstances to comply with those requirements.

However, as soon as practicable, the plan administrator (or financial institution in the case of IRAs) must make a reasonable attempt to assemble any forgone documentation. For example, if spousal consent is required for a plan loan or distribution and the plan terms require production of a death certificate if the employee claims his or her spouse is deceased, the plan will not be disqualified for failure to operate in accordance with its terms if it makes a loan or distribution to an individual described in the above "As described below" in the absence of a death certificate if it is reasonable to believe, under the circumstances, that the spouse is deceased, the loan or distribution is made no later than January 31, 2018, and the plan administrator makes reasonable efforts to obtain the death certificate as soon as practicable.

For purposes of the Announcement, "retirement plan" has the same meaning as "eligible retirement plan" under §402(c)(8)(B).

In general, the normal spousal consent rules continue to apply, and, except to the extent the distribution consists of already-taxed amounts, any distribution made pursuant to the relief provided in the Announcement will be includible in gross income and generally subject to the 10% additional tax under §72(t).

IRS notes that the relief that it is currently providing is similar to the relief provided last year to Louisiana flood victims and victims of Hurricane Matthew.

The Department of Labor has said that it will not treat any person as having violated the provisions of Title I of the Employee Retirement Income Security Act solely because that person complied with the provisions of the Announcement.

Announcement 2017-4, 2017-16 IRB.

Relief from the retirement plan prohibited transaction taxes under §4975 and any related reporting requirements, to conform to the temporary enforcement policy described by the Department of Labor(DOL) with respect to the fiduciary duty rule.

Code penalty for retirement plan prohibited transactions. §4975(c)(1)(A) through §4975(c)(1)(D) prohibit the direct or indirect sale, exchange, leasing of property, or loan of money, or other extension of credit, between a plan (including an individual retirement account or individual retirement annuity(IRA)) and a disqualified person, or the direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan. §4975(c)(1)(E) prohibits fiduciaries from dealing with the income or assets of a plan in their own interest or for their own account or receiving any consideration for their own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

§4975 imposes an excise tax on each prohibited transaction.

§4975(d) provides a series of exemptions from the prohibitions, and §4975(e) provides a series of definitions, including the definition of a disqualified person to whom the tax may apply. §4975(e)(2)(A) provides that a disqualified person includes a fiduciary.

The Employee Retirement Income Security Act of 1974, as amended(ERISA), contains provisions on prohibited transactions that are substantially similar to the provisions of §4975, although the ERISA provisions prohibit the fiduciary from engaging in the transactions and provide for civil liability and remedies rather than imposing an excise tax. The DOL is the agency responsible for interpreting and enforcing the ERISA provisions as they apply to employee benefit plans. ERISA §408(a) includes an authorization for the Secretary of Labor to grant administrative exemptions from ERISA's prohibited transaction provisions that parallels the similar authorization in §4975(c) for the Treasury Department to grant administrative exemptions from the prohibited transaction provisions in the Code.

To ensure consistency in application, Reorganization Plan No. 4 of 1978, 5 U.S.C. App. 1, 92 Stat. 3790, provides that the authority of the Treasury Department to issue regulations, rulings, opinions, and exemptions under §4975 is transferred, with certain exceptions not relevant here, to the Secretary of Labor. As a result, IRS is responsible for enforcing the excise tax provisions in §4975, but generally is bound by the DOL's interpretive regulations, rulings, opinions, and exemptions in determining whether a prohibited transaction has occurred.

On April 8, 2016, the DOL published a final regulation defining who is a "fiduciary" of an employee benefit plan under §3(21)(A)(ii) of ERISA as a result of giving investment advice to a plan or its participants or beneficiaries. The final rule also applies to the definition of a fiduciary of a plan under

§4975(e)(3)(B). The final rule treats persons who provide investment advice or recommendations for a fee or other compensation with respect to assets of a plan as fiduciaries in a wider array of advice relationships than was true of the prior regulatory definition. On this same date, the DOL published prohibited transaction exemptions(PTEs), which provide two new administrative class exemptions from the prohibited transaction provisions of ERISA and the Code, as well as amendments to previously granted exemptions.

The final fiduciary duty rule became effective on June 7, 2016, and has an applicability date of April 10, 2017. The PTEs generally also have an applicability date of April 10, 2017.

On February 3, 2017, President Trump directed the DOL to examine whether the fiduciary duty rule may adversely affect the ability of Americans to gain access to retirement information and financial advice and to prepare an updated economic and legal analysis concerning the likely impact of the rule as part of that examination.

The DOL issued FAB 2017-01 on March 10, 2017, to announce a temporary enforcement policy related to an earlier proposal to extend for 60 days the applicability date of the fiduciary duty rule and the related PTEs. The policy provides that:

a. In the event the DOL issues a final rule after April 10 implementing a delay in the applicability date of the fiduciary duty rule and related PTEs, the DOL will not initiate an enforcement action because an adviser or financial institution did not satisfy conditions of the rule or the PTEs during the "gap" period in which the rule becomes applicable before a delay is implemented, including a failure to provide retirement investors with disclosures or other documents intended to comply with provisions of the rule or the related PTEs.

b. In the event the DOL decides not to issue a delay in the fiduciary duty rule and related PTEs, the DOL will not initiate an enforcement action because an adviser or financial institution, as of the April 10 applicability date of the rule, failed to satisfy conditions of the rule or the PTEs, provided that the adviser or financial institution satisfies the applicable conditions of the rule or PTEs, including sending out required disclosures or other documents to retirement investors, within a reasonable period after the publication of a decision not to delay the April 10 applicability date.

IRS issues transition relief. Because the Code and ERISA contemplate consistency in the enforcement of the prohibited transaction rules by IRS and the DOL, IRS has determined that it is appropriate to adopt a temporary excise tax non-applicability policy that conforms with the DOL's temporary enforcement policy described in FAB 2017-01.

Accordingly, IRS will not apply §4975 and related reporting obligations with respect to any transaction or agreement to which the DOL's temporary enforcement policy, or other subsequent related enforcement guidance, would apply.

V. PROCEDURES, PENALTIES AND OTHER

Abdiwali Suldan Mohamed, TC Summary Opinion 2017-69

Return preparer, who was provided a full opportunity before the IRS Office of Appeals (Appeals) to challenge the imposition of §6695(g) penalties for failing to comply with the earned income tax credit (EITC) due diligence requirements, was precluded from raising that issue at a collection due process (CDP) hearing.

Under §6695(g), a tax return preparer with respect to any return or claim for refund-who fails to comply with the due diligence requirements imposed by the regulations with respect to determining eligibility for, or the amount of, the credit allowable by EITC under §32 - must pay a penalty of $500 for each such failure.

Observation: Effective for tax years beginning after December 31, 2015-years not at issue in this case- §6695(g) was amended by the Consolidated Appropriations Act, 2016 (P. L. 114-113, div. Q, sec. 207(a)(1) and (2)), to also extend the penalty to tax return preparers determining eligibility for, or the amount of, the credit under §24 (the child tax credit) and §25A(a)(1) (the Hope Scholarship Credit).

Regulation §1.6695-2(b) sets out due diligence requirements that a tax return preparer must satisfy to avoid a penalty under §6695(g). These include preparing and retaining certain IRS forms (e.g., Form 8867 (Paid Preparer's Earned Income Credit Checklist) and the Earned Income Credit Worksheet). In addition, the tax return preparer must not know, or have reason to know, that any information that he relied upon in determining a taxpayer's eligibility for, or the amount of, the EITC is incorrect. While §6696(b) provides that the deficiency procedures do not apply with respect to the assessment or collection of the §6695 penalties, a return preparer nevertheless may request an appeal of an initial determination of a §6695(g) penalty within IRS.

Under §6751(a), IRS must generally provide information about any penalty it imposes under the Code. Specifically, with each notice of a penalty, IRS must include information with respect to the name of the penalty, the Code section under which the penalty is imposed, and a computation of the penalty. Under §6751(b)(1), no penalty can generally be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination.

Appeals is responsible for conducting administrative hearings in collection matters. (§6330(b)(1)) Once IRS decides to levy to collect a penalty, it must notify the taxpayer in writing of the right to a hearing under §6330(a)(1) (i.e., a CDP hearing). Appeals must verify that the requirements of any applicable law or administrative procedure have been met in processing the case. (§6330(c)(1), §6330(c)(3)(A)) The Appeals Office must also consider any issues raised by the person that relate to the unpaid tax or proposed levy, including offers of collection alternatives, appropriate spousal defenses, and challenges to the appropriateness of the collection action. (§6330(c)(2)(A), §6330(c)(3)(B))

At a CDP hearing, a person may challenge the existence or amount of his underlying tax liability if the person did not receive a notice of deficiency or did not otherwise have an opportunity to dispute such tax liability. (§6330(c)(2)(B)) Finally, Appeals must consider whether the collection action balances the need for efficient collection against the person's concern that collection be no more intrusive than necessary. (§6330(c)(3)(C))

§6330(c)(4)(A) bars CDP review of any issue that was raised and considered in any previous administrative or judicial proceeding if the person seeking to raise the issue participated meaningfully in the proceeding.

An opportunity to dispute the underlying liability includes a prior opportunity for a conference with Appeals that was offered either before or after the assessment of the liability. However, an opportunity for a conference with the Appeals prior to the assessment of a tax subject to deficiency procedures is not a prior opportunity for this purpose. (Regulation §301.6320-1(e)(3), Q&A E-2)
A taxpayer who is dissatisfied with the findings or conclusions of the CDP hearing can appeal the determination to the Tax Court. (§6330(d)(1)) When the Tax Court receives an appeal from a CDP hearing, however, its review is limited to issues that were properly raised during the CDP hearing. (Goza, (2000) 114 TC 176)

Mr. Mohamed, a certified public accountant (CPA), operated a tax return preparation business under the name MiniMax CPA, PS. In early 2014, he prepared and filed more than 300 Federal income tax returns for his clients for the 2013 tax year. Some of his clients' tax returns were examined in March and April 2014 as part of an IRS EITC due diligence audit program.

Mr. Mohamed met with the tax compliance officer (TCO)-i.e., the examiner assigned to determine whether he had complied with the EITC due diligence requirements-to review his records and files related to 50 tax returns that he had prepared for the 2013 tax year. The TCO prepared a detailed report titled "EITC Due Diligence Penalty Lead Sheet," dated April 24, 2014 (audit report), in which she concluded that Mr. Mohamed had failed to satisfy the EITC due diligence requirements in preparing 20 of the 50 tax returns selected for review. The TCO recommended that IRS impose a $10,000 penalty (20 × $500) under §6695(g).

On April 28, 2014, the TCO prepared a Form 8484 (Report of Suspected Practitioner Misconduct and Report of Appraiser Penalty), for submission to the Office of Professional Responsibility (OPR). The TCO attached to the Form 8484 a copy of the audit report. On April 28, 2014, the TCO's acting immediate supervisor attached her digital signature to "Part E-Management Approval" of the Form 8484.

At his request, on May 8, 2015 Mr. Mohamed met with an Appeals Officer (AO) for about six hours to review his files related to the 20 tax returns identified in the audit report. In conjunction with that meeting, the AO determined that §6695(g) penalties shouldn't be imposed on Mr. Mohamed for 5 of the 20 tax returns in question, and she requested that he provide additional information for about 4 other tax returns (which Mr. Mohamed provided). On June 26, 2015, Mr. Mohamed participated in a telephone conference with the AO, and she informed him that she would recommend that 14 penalties be assessed against him under §6695(g).

On July 9, 2015, the Appeals team manager sent Mr. Mohamed a closing letter stating that the Appeals Office had determined that he failed to satisfy EITC due diligence requirements in preparing 14 tax returns for the 2013 tax year and that penalties totaling $7,000 would be assessed against him. The letter stated that he could contest the determination by paying the penalties, filing a claim for refund with IRS, and, if the refund claim was denied, filing a refund suit in Federal district court or the U.S. Court of Federal Claims. The letter was accompanied by a report which included a brief description and explanation of Appeals' rationale for sustaining or conceding the penalties for the 20 tax returns in question.

On August 3, 2015, IRS entered an assessment of $7,000 against Mr. Mohamed. IRS sent him a notice and demand for payment, but he failed to pay. On Nov. 26, 2015, IRS sent Mr. Mohamed a notice of intent to levy which included notice of his right to request an administrative hearing before Appeals. Mr. Mohamed subsequently submitted to Appeals a timely Form 12153 (Request for a Collection Due

Process or Equivalent Hearing), indicating that he believed the proposed levy action was unwarranted.

The Appeals administrative hearing was conducted by way of a telephone conference call. Although Mr. Mohamed maintained that he should be allowed to challenge the underlying assessment, the SO explained that she had reviewed his transcripts of account and determined that he had previously challenged the penalties in question before Appeals. Consequently, he was barred from challenging his underlying liabilities in the administrative hearing. Because Mr. Mohamed otherwise declined to offer or agree to a collection alternative, Appeals issued a notice of determination sustaining the proposed levy action. Mr. Mohamed invoked the Tax Court's jurisdiction by filing a timely petition for review under §6330.

The Tax Court determined that the record showed that in 2015, Mr. Mohamed was provided a full and fair opportunity to challenge the imposition of the disputed penalties before Appeals and he meaningfully participated in that proceeding. The Court agreed with Appeals' determination that Mr. Mohamed was barred from challenging his underlying liability for the §6695(g) penalties during the collection review proceeding because (although he did not receive a notice of deficiency) he had previously taken advantage of the opportunity to have Appeals review the matter. The taxpayer was provided a full and fair opportunity to challenge the imposition of the disputed penalties before Appeals and he meaningfully participated in that proceeding. While he would have preferred to continue to dispute his liability, the Court was satisfied that Appeals conducted a fair and comprehensive review of the matter and acted properly in concluding the matter by issuing its closing letter.

While Mr. Mohamed did not dispute that he requested and received Appeals review of the §6695(g) penalties in 2015 before the proposed levy action, he contended that Appeals prematurely terminated its review in 2015 and issued its closing letter without giving him a final chance to rebut the AO's conclusions. The Tax Court disagreed. After the TCO recommended that 20 penalties be assessed against him under §6695(g), he requested and was granted Appeals review. He again actively participated in Appeals review process: he attended a lengthy meeting with the AO assigned to review the matter, submitted additional documentation to the AO as requested, and participated in a follow-up conference call. Ultimately, Appeals (through the Appeals team manager) issued a closing letter to the taxpayer informing him that §6695(g) penalties would be assessed in respect of 14 tax returns that he had prepared.

The Tax Court also found that the requirement under §6751(b) for supervisory approval of the initial penalty determination was satisfied when the TCO's (acting) immediate supervisor approved the initial determination to impose 20 §6695(g) penalties on Mr. Mohamed when she signed the Form 8484 and approved the referral of the matter (including the audit report) to the OPR. Although Form 8484 (which provides information to the OPR about questionable practitioner conduct) does not on its face function to authorize the assessment of a penalty, in this case the TCO's acting immediate supervisor placed her digital signature on the Form 8484 indicating that she agreed with the referral of the matter to the OPR and that she approved the audit report (attached to the Form 8484) which recommended that 20 §6695(g) penalties be assessed against Mr. Mohamed. The audit report included a detailed explanation in support of each of the 20 penalties. Under the circumstances of this case, the Tax Court concluded that the TCO's initial determination to assess the penalties in dispute was personally approved in writing by her immediate supervisor.

The Court found that Mr. Mohamed had not raised any other challenge to Appeals' determination sustaining the proposed levy action. And, the record showed that Appeals fulfilled its obligations as prescribed in §6330. In the absence of a valid defense to the proposed levy or a viable collection alternative, the proposed levy action balanced the need for efficient collection against Mr. Mohamed's concern that collection be no more intrusive than necessary.

Allen, TC Memo 2017-64.

Because the Internal Revenue Manual provides that meeting estimated tax payment requirements is a prerequisite for IRS to accept a partial-pay installment agreement (PPIA), an IRS settlement offer acted reasonably in rejecting a taxpayer's installment agreement. The agreement called for the taxpayer to first make his past-due estimated tax payment, the taxpayer did not make that payment, and the taxpayer advised the settlement officer that he could not make that payment.

§6330(a)(1) requires IRS to give a taxpayer written notice when IRS intends to levy upon the taxpayer's property. The notice must inform the taxpayer of the right to request an administrative collection due process (CDP) hearing in the IRS Appeals Office.

If a taxpayer is entitled to a CDP hearing before a levy, the Appeals officer conducting the hearing must verify that the requirements of any applicable law or administrative procedure have been met, must take into consideration the issues raised by the person subject to the notice of levy, and must balance the need for tax collection with legitimate taxpayer concerns. (§6330(c)(3))

§6159 authorizes IRS to enter into an installment agreement if it determines that doing so will facilitate full or partial collection of a taxpayer's unpaid liability. Subject to exceptions not relevant here, the decision to accept or reject an installment agreement lies within IRS's discretion. (Regulation §301.6159-1(a), Regulation §301.6159-1(c)(1)(i))

And, IRS is authorized to compromise a taxpayer's income tax liability (via an offer-in-compromise, or OIC) under §7122(a).

A taxpayer may appeal the Appeals Office determination to the Tax Court within 30 days of the determination. (§6330(d)(1)) Where there is no challenge to the underlying tax liabilities, the Court reviews IRS's determination for an abuse of discretion. (*Goza,* (2000) 114 TC 176)

The taxpayer, Mr. Allen, had unpaid assessed taxes and penalties. IRS issued him a Final Notice of Intent to Levy. Allen timely requested a CDP hearing.

In a January, 2015 letter that preceded the CDP hearing, the IRS settlement officer (SO) told Allen that he should bring to the hearing proof that he had made all required current year estimated tax payments. The SO noted that, while past-due estimated tax payments "may be included in an installment agreement," an OIC "cannot be accepted unless estimated tax payments are paid in full."

At the May, 2015 hearing, the SO explained to Allen that he was not currently in compliance with his tax obligations because he had failed to make an estimated tax payment for the first quarter of 2015. For that reason, he would be ineligible for an OIC but could still be considered for an installment agreement. Allen initially proposed an installment agreement of $500 per month.

After reviewing Allen's bank statements and business records, the SO determined that Allen had monthly disposable income of $809. The SO determined that Allen thus qualified for an installment agreement under which he would pay $809 per month over the balance of the collections period.

Because Allen's total outstanding tax liabilities exceeded $93,000, monthly payments of $809 would not enable him to discharge those liabilities in full before the expiration of the collections period. The SO thus treated Allen as having requested a PPIA. After consulting the Internal Revenue Manual (IRM), the SO concluded that Allen, under a PPIA, would not be eligible to have his past-due estimated tax obligation for the first quarter of 2015 rolled into the monthly installments. Rather, the SO informed him that he would need to make an upfront payment of $1,865, representing that past-due obligation, as a precondition for entering into the PPIA.

On May 21, 2015, Allen told the SO that he would agree to an installment agreement of $809 per month and would make the required upfront payment of $1,865. The SO gave Allen until June 8 to make the upfront payment; the SO later extended that deadline to June 12. On June 18, Allen advised the SO that he could not make the $1,865 payment. The SO replied that he would then close the case.

On July 24, 2015, IRS issued a notice of determination upholding the proposed levy, and Allen timely petitioned the Tax Court. In his petition he assigned error to the SO's requirement that he pay $1,865 toward his delinquent 2015 estimated tax obligation in order to enter into the proposed PPIA, as well as to the SO's alleged failure to consider his "current financial situation."

The Court rejected both of the taxpayer's arguments and found that the IRS SO did not abuse his discretion when he upheld the proposed levy.

The Allen argued that, by requiring that he pay $1,865 in estimated tax payments for the first quarter of 2015 as a precondition to his PPIA, the SO violated the second and third prongs of the three-pronged test of §6330(c)(3).

The Court said that the type of agreement that Allen proposed, and that the SO was willing to accept, was a PPIA. IRS has created guidelines, set out in the IRM, for settlement officers to follow in determining the terms of a PPIA for a taxpayer who can pay some (but not all) of his outstanding tax liability. In such situations, a prerequisite for preparing a PPIA for approval and processing is that the taxpayer be "in compliance with filing, withholding, federal tax deposit and estimated tax payment requirements." (IRM pt. 5.14.2.1.4(1))

The Court said that it has previously ruled that a settlement officer properly exercises his discretion by adhering to IRM provisions governing acceptance of collection alternatives. See, for example, *Veneziano,* TC Memo 2011-160. The Tax Court has accordingly held that an Appeals officer does not abuse his discretion in declining to enter into an installment agreement where the taxpayer is unwilling or unable to comply with his on-going estimated tax obligations. See, for example, *Boulware*, TC Memo 2014-80.

The taxpayer in Boulware argued that the settlement officer would have acted within his discretion if he had agreed to roll the delinquent estimated tax payment into the installment agreement instead of requiring that it be paid up front. The Boulware Court nevertheless concluded that, although the settlement officer could accept an installment agreement that included the taxpayer's current estimated tax liabilities, she acted within her discretion in declining to do so.

The Court here said that it reached the same conclusion: the SO did not abuse his discretion when he insisted, consistently with the IRM, that Allen make an upfront payment of $1,865 to discharge his estimated tax liability for the first quarter of 2015 as a condition of executing the PPIA.

Allen focused on the wording of the SO's January 2015, letter, which stated that past-due estimated tax payments "may be included in an installment agreement." But the letter by its terms did not promise this treatment; after consulting the IRM, the SO reasonably determined that an upfront payment of the taxpayer's delinquent estimated tax payment should be required because he was offering only a PPIA.

Allen also contended that he "was not afforded the opportunity to provide current financial information" and that the SO did not sufficiently explore changes to his financial condition. But, the Court said, the burden of updating the SO about changes in the taxpayer's financial situation rests on the taxpayer. Nothing in the record suggested that the SO was unreceptive to communications from Allen on this subject. Indeed, the SO regularly asked Allen to supply relevant financial documentation and readily accommodated all of his requests to extend deadlines and postpone meetings. And the Court said that it declined to impose on settlement officers an affirmative obligation to ferret out how a taxpayer's financial situation might have changed before formulating a collection alternative.

Allred, (CA 6 5/9/2017) 119 AFTR 2d ¶ 2017-741.

The Court of Appeals for the Sixth Circuit, affirming a district court decision, has rejected a taxpayer's argument that he was entitled to a refund under the mitigation provisions because income that he reported on a closed year return was also reported on an amended return of the estate of his business partner. IRS had rejected the business partner's amended return because it was filed late, and the taxpayer argued that IRS should not have rejected that return because IRS should have applied the 6-year, not the 3-year, statute of limitations (SOL).

§6501(a) generally provides that a valid assessment of income tax liability may not be made more than three years after the later of the date the tax return was filed or the due date of the tax return. However, if a taxpayer omits an amount from gross income that is properly includable and that amount is more than 25% of the amount of gross income stated in the return, "the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within six years after the return was filed." (§6501(e)(1)(A)(i))

The mitigation provisions of §1311 - §1314 allow for the correction of an error made in a closed tax year, by extending the limitations period up to one year from the date a final determination is made. Thus, claims that are barred by the statute of limitations may still be brought if the mitigation provisions apply. The following conditions must be met:

1. There must be a "determination" (as defined in §1313(a)) for an open tax year. (§1311(a))

2. The determination must have caused one of the errors described in §1312.

3. On the date of that determination, any adjustment to correct the error is barred by operation of aw (other than a §7122 compromise or the mitigation provisions). (§1311(a))

4. Subject to exceptions, the determination must adopt a position maintained by a party that is inconsistent with the error that has occurred. (§1311(b)(1))

One of the errors described in §1312 is a "double inclusion," i.e., the inclusion in gross income of an item which was erroneously included in the gross income of a related party. (§1312(1)) A partner in a partnership is a related party for this purpose. (§1313(c)(6))

The taxpayers were Mr. and Mrs. Allred. Fred Bayne and Mr. Allred each owned a 50% member interest in an LLC. After Bayne passed away in 2007, Allred purchased Bayne's member interest. As Allred then became the sole member of the LLC, the LLC's 2007 federal tax return reflected that he had received all of the LLC's income for that year. From 2007 onward, the Allreds reported all of the LLC's income on their own individual returns.

Bayne's estate subsequently sued Allred, disputing his right to acquire Bayne's member interest in the LLC. Pending the outcome of that litigation, the LLC and the Allreds each filed amended tax returns for the years 2007-13, reflecting Mr. Allred's ownership interest of only 50% of the LLC. However, consistent with the LLC's original returns, the estate did not report any income from the LLC, or pay any related income tax, during this time.

The estate eventually prevailed in the litigation. Accordingly, the Allreds began submitting refund claims for the amended returns they had filed during litigation. The estate meanwhile filed amended returns for 2007-13, reporting 50% of the LLC's income and paying the resulting tax. The net result was the reallocation of income and income tax payments between the Allreds and the estate for those tax years, except for 2009.

The Allreds' 2009 amended return was filed late. IRS denied it as untimely filed. The IRS also denied as untimely the estate's amended return for that year. Consequently, the Allreds paid taxes on all of the LLC's 2009 income, despite owning only a 50% share, while the estate paid none.

The Allreds filed a district court suit on the grounds that the Code's mitigation provisions provided relief. The district court ruled against them. (*Allred,* (DC TN 2016) 117 AFTR 2d 2016-677) The Allreds appealed.

The Appeals Court agreed with the lower court that the Code's mitigation provisions did not provide relief to the taxpayers.

The Allreds contended that IRS improperly rejected the estate's 2009 amended return and instead should have accepted the estate's amended return and tax payment under the 6-year rule in §6501(e)(1)(A)(i). The Court said that, in effect, the Allreds argued that the Court should require IRS to apply the 6-year exception and thus create the double inclusion that would allow the Allreds to fall within the mitigation provisions. The Allreds argued, and the Court agreed, that the estate was a related party because it was Mr. Allred's partner in the LLC in 2009.

The Court rejected the 6-year SOL argument. It said that the Allreds cited no authority that would allow the Court to do what they requested. The plain language of the statute does not appear to obligate IRS to apply the exception and assess the tax; it provides that "the tax may be assessed." The Allreds cited no authority to the contrary. And, the Allreds did not allege that a failure to apply the 6-year exception against a related taxpayer falls within any of the errors described in §1312(1) - §1312(7).

The Court said that, although the mitigation provisions serve an equitable purpose, Congress did not intend those provisions to provide relief in all situations in which just claims are precluded by statutes of limitations.

James Awad, TC Memo 2017-108.

Where a whistleblower provided information to IRS in 2008 and the taxpayer entered into an offshore voluntary disclosure agreement in 2010 resulting in a more than $2 million assessment, the administrative action taken by IRS against the taxpayer was not based on the whistleblower's information, and therefore he was not entitled to an award under §7623.

§7623(b) provides that if IRS proceeds with any administrative or judicial action based on information brought to IRS's attention by an individual, the individual will receive a percentage of the collected proceeds as an award. Under Regulation §301.7623-2(b), IRS "proceeds based on information provided by a whistleblower" when, for example, IRS initiates a new action, expands the scope of an ongoing action, or continues to pursue an ongoing action, that IRS would not have initiated, expanded the scope of, or continued to pursue, but for the information provided.

Under §7623(a), IRS has discretionary authority to pay awards to informants (i.e., whistleblowers) in the sums it considers necessary for the detection of tax underpayments, or for the detection, trial, and punishment of tax law violators.

Under §7623(b), individuals are entitled to receive an award of 15% to 30% (or lower amounts in cases of less substantial contribution) of the collected proceeds resulting from an action based on information provided by the whistleblower in any action: (§7623(b)(5))

a. Against any taxpayer, but in the case of any individual taxpayer, only if such individual's gross income exceeds $200,000 for any tax year subject to such action, (§7623(b)(5)(A)) and

b. If the tax, penalties, interest, additions to tax, and additional amounts in dispute exceed $2 million. (§7623(b)(5)(B))

With respect to nondiscretionary whistleblower awards, §7623(b)(4) provides that any determination regarding an award may, within 30 days of such determination, be appealed to the Tax Court (and the Tax Court will have jurisdiction with respect to that matter). A whistleblower may then appeal the Tax Court's decision to the applicable Court of Appeals. (§7482(a))

On November 18, 2008, James Awad provided information to the IRS Whistleblower Office with regard to Husband's, Wife's and their three adult children's alleged failure to disclose their ownership interests in foreign bank accounts. Awad alleged that Husband was likely transferring millions of untaxed dollars to these accounts. While Awad provided the name of the bank, he did not list any account numbers or give other identifying information about the alleged accounts.

The Whistleblower Office confirmed receipt of the claim and informed him that his claim had been assigned to analyst. In February of 2009, the IRS Whistleblower Office forwarded Awad's information to the Large Business & International Division (LB&I), which in June of 2009 declined to examine Husband and Wife's returns because of the lack of any documentation showing that the accounts existed or that any money was transferred.

In August of 2009, Husband died while LB&I was considering Awad's information. In January of 2010, Wife and her adult children filed voluntary disclosures with the Criminal Investigation Division (CID) under the offshore voluntary disclosure program (OVDP). They reported income from a previously undisclosed account at the same foreign bank Awad had identified. The taxpayers' voluntary disclosures included account information and amended returns reporting previously undisclosed income for tax years 2003 through 2008.

CID accepted the voluntary disclosures and forwarded them to the Small Business/Self Employed Division (SB/SE) for examination. The SB/SE examination resulted in the assessment of over $2 million in income tax, accuracy-related penalties, and interest. In a closing agreement, Wife and Husband's estate also agreed to pay, and IRS agreed to accept a title 26 miscellaneous penalty "in lieu of any other penalties that the...[IRS] may impose with respect to the offshore financial arrangements that were the subject of the voluntary disclosure." The examination of the taxpayers' returns was officially closed in November of 2011

Although the IRS Whistleblower Office forwarded Awad's information to SB/SE in September 2010, the revenue agent who conducted the examination denied using it. He provided the Whistleblower Office with a written statement indicating that the sole cause of the examination was the taxpayers' voluntary disclosure. He wrote that there was no indication in the case files that Awad's information initiated the investigation or assisted to gather any offshore accounts.

In August 2013, the IRS Whistleblower Office also forwarded Awad's information to SB/SE's Estate and Gift Tax Group (E&G), which had selected Husband's estate tax return for examination. The revenue agent who was conducting the examination asserted that Awad's information was not relevant to his investigation and stated that this information had nothing to do with Husband's estate tax return, as it only dealt with income tax issues.

On January 28, 2014, the IRS Whistleblower Office issued a determination denying Awad's claim for a whistleblower award.

The Tax Court held that, because the administrative action taken by IRS against Husband and Wife was not based on Awad's information, he was not entitled to a whistleblower award.

The Court found that the record showed that, on three separate occasions, the

Whistleblower Office had forwarded Awad's information to other IRS operating divisions for further investigation: (1) to LB&I in February 2009; (2) to SB/SE in September 2010; and (3) to E&G in August 2013. Because LB&I did not proceed with administrative or judicial action against the taxpayers, Awad was not entitled to an award on the basis of this referral. Because E&G did not initiate, expand the scope of, or continue to pursue its examination of Husband's estate tax return on account of Awad's information, he was not entitled to an award on the basis of this referral.

However, unlike LB&I and E&G, SB/SE opted to examine the taxpayers' returns. The parties disagreed about whether Awad's information prompted and/or facilitated the examination. Under IRS's theory of the case, the taxpayers' voluntary disclosure was the sole cause of the examination and resulting adjustments. Under Awad's theory of the case, IRS had received his information about the taxpayers' undisclosed bank accounts before it accepted their voluntary disclosure; by admitting the taxpayers into the OVDP when it was already on notice of their noncompliance, IRS disregarded its own rules and procedures which was evidence that the IRS shepherded the taxpayers into the OVDP in order to avoid paying him an award. Awad further cited IRS's apparent refusal to provide him with documents concerning the taxpayers' acceptance into the OVDP as evidence of this scheme.

The Tax Court found that Awad was not entitled to an award on the basis of the referral to SB/SE. In a written statement to the Whistleblower Office, the SB/SE examiner stated that there was no evidence in his case file that Awad's information had prompted the examination. He also confirmed to the Whistleblower Office that he did not use Awad's information during his examination of the taxpayers' voluntary disclosure submission. There was nothing in the record that showed or even suggested otherwise. Also absent from the record was any evidence of a causal connection between Awad's whistleblower submission and the taxpayers' decision to come forward to IRS.

Furthermore, IRS's purported disregard of its own rules in accepting the taxpayers' voluntary disclosure did not support the inference that IRS used the OVDP as a cover for denying Awad an award. The rule Awad primarily relied on was found in the Internal Revenue Manual (IRM), which does not have the force of law and is not binding on IRS. In addition, Congress explicitly authorized IRS to enter into closing agreements like the one it reached with the taxpayers. §7121 authorizes IRS to enter into a written closing agreement "with any person relating to the liability of such person...in respect of any internal revenue tax for any taxable period." Such agreements "may be used for procedural economy, or to prevent a dispute from arising."

Nor could the Tax Court conclude that IRS's apparent refusal to provide Awad with certain documents evidenced such a scheme. If a party was troubled by another party's response to a discovery request, Rule 72(b)(2) permitted the requesting party to file an appropriate motion with the Court. Having proceeded to trial without taking this step, Awad could not cite the failure to produce the documents as grounds for requesting a negative inference against IRS.

The Court also noted that it did not need to decide the standard of review in this case because it would sustain IRS's determination under either a de novo (anew) or an abuse of discretion standard of review.

Balice, (DC NJ 8/9/2017) 119 AFTR 2d ¶ 2017-5134.

A district court has held that a trust to which the taxpayer transferred his residence was the taxpayer's nominee and that therefore IRS's right to foreclose on property subject to a federal tax lien extended to that residence. The court also ruled on the timeliness of IRS's foreclosure action and held that the taxpayer's argument that he never received a notice of deficiency was overcome by the fact that he promptly petitioned the court.

If IRS determines that there is a deficiency in respect of any tax, IRS may send a notice of the deficiency to the taxpayer by certified mail or registered mail. (§6212(a))

§6321 imposes a lien on all property and property rights of a taxpayer liable for taxes after a demand for the payment of the taxes has been made and the taxpayer fails to pay those taxes. The lien arises at the time assessment is made and continues until the liability is satisfied or becomes unenforceable by lapse of time. (§6322) The filing of a Notice of Federal Tax Lien ensures priority of the Federal tax lien over claims of most competing creditors. (§6323)

In any case where there has been a refusal or neglect to pay any tax, or to discharge any liability in respect thereof, the U.S. Attorney General or his delegate, at the request of IRS, may direct a civil action to be filed in a district court to enforce the lien. (§7403(a))

A nominee is a person or entity who "holds bare legal title to property for the benefit of another." In determining nominee status, the court considers the following non-exhaustive factors: (1) whether the nominee paid adequate consideration for the property; (2) whether the property of the taxpayer was placed in the name of the nominee in anticipation of collection activity; (3) whether there is a close relationship between transferor and the nominee; (4) whether the transfer was recorded; (5) whether the transferor continues to possess the property; and (6) whether the transferor retains enjoyment of the benefits of the transferred property. (*Oxford Capital v. U.S.,* (CA 5 2000) 85 AFTR 2d 2000-1840)

A levy or court proceeding to collect taxes must commence within ten years after the assessment of a tax, but if a timely proceeding in court for the collection of a tax is commenced, the period during which such tax may be collected by levy is extended and does not expire until the liability for the tax (or a judgment against the taxpayer arising from such liability) is satisfied or becomes unenforceable. (§6502(a))

The taxpayers, Mr. and Mrs. Balice, had unpaid tax liabilities for many tax years including 1994, 2003, 2007 and 2008. In 2008 and 2012, Mr. Balice brought suit in Tax Court with respect to the 1994 and 2003 liabilities, respectively, and the Tax Court found in favor of IRS with respect to those years.

The Balices had owned and lived in property on Maple Avenue in Metuchen, New Jersey. In August of 1994, the Balices, saddled with outstanding federal income tax and other liabilities, attended a seminar that instructed attendees on how to create trusts to obtain tax benefits. Thereafter, on August 28, 1994, the Balices executed a quitclaim deed purporting to transfer title of the Maple Avenue property to the Rosewater Trust ("Rosewater"). The Balices did not receive consideration for the transfer. Mrs. Balice was Rosewater's trustee.

The Balices opened a checking account in Rosewater's name. The Balices exercised complete control over the checking account; all deposits into the account were from the Balices. All statements for the Rosewater checking account went to the Balices' home address. Following transfer to Rosewater, the Balices continued to live in and exercise control over the Maple Avenue property.

At one of the Tax Court trials, Mrs. Balice admitted that Rosewater was fictitious and set up to hold title to the Maple Avenue property and protect it from federal tax and other liabilities.

In 2014, IRS filed the current action, against the Balices and Amboy Bank, which held the mortgage on the Maple Avenue property, to reduce to judgment Mr. Balice's 2007 and 2008 tax liabilities and to foreclose on the Maple Avenue property.

Mr. Balice argued that the Tax Court's orders should be set aside because the Balices never received notices of deficiency. The court here rejected this argument.

The court said that it was entirely implausible that Mr. Balice never received a notice of deficiency and yet challenged IRS's assessment in Tax Court. "It follows that there is no prejudice. Any procedural defect that may have existed in IRS's service of the notice of deficiency did not deprive Balice of a full and fair opportunity to litigate the merits of his deficiency."

Citing the Supreme Court in *G. M. Leasing Corporation ,* (S Ct 1977) 39 AFTR 2d 77-475, the court said that IRS's foreclosure right under §7403(a) extends to property held by a taxpayer's nominee.

And, it held that Rosewater was Mr. Balice's nominee. It said that IRS's evidence established that five out of six factors supported the nominee theory. The exception was factor four; failure to record a conveyance. The Balices did record a quitclaim deed conveying the Maple Avenue property to Rosewater. Nevertheless, it said, considering the substantial, undisputed evidence supporting the other five factors, factor four was not dispositive. The Third Circuit and its constituent courts have arrived at the same conclusion when faced with this balance of factors. See, e.g., *Patras,* (DC NJ 2012) 111 AFTR 2d 2013-315 ("Although the conveyance to [the nominee] was recorded, this factor is not dispositive given the substantial evidence supporting the other factors.")

Amboy Bank argued that a statute of limitations prohibited IRS from its foreclosure actions. The court rejected Amboy's argument.

Amboy contended that 28 U.S.C. §2462 (which sets a 5-year statute of limitations on enforcing "any civil fine, penalty or forfeiture"), rather than §6502 (which sets a 10-year statute of limitations on the collection of taxes from the time the taxes are assessed), applied. That was so, said Amboy, because IRS's nominee/alter ego claims were not "assessments." The 5-year period under 28 U.S.C. §2462, said Amboy, began running when IRS's claim against the Maple Avenue property accrued, which Amboy said was when IRS was put on notice that the Maple Avenue property had been transferred to Rosewater.

The court said that Amboy cited no case law to support its assertion that IRS's nominee theory constituted an independent claim against Rosewater, or that 28 U.S.C. §2462 rather than §6502 applied here. The court said that what case law does exist overwhelmingly suggests that where a tax levy or collection of judgment would be timely as against a taxpayer, a tax levy or collection of judgment against the taxpayer's nominee is also timely; no separate claim need be asserted against the nominee. For these purposes, the taxpayer and his nominee are considered one and the same; IRS's current suit was not an independent cause of action, but simply an exercise in tracking the taxpayer's assets.

And, the court said, the 5-year statute of limitations provided for in 28 U.S.C. §2462 did not apply here. Section 2462 applies only "except as otherwise provided by Act of Congress." §6502 constitutes such an act that sets a specific statute of limitations for collection of taxes after assessment.

In this case, IRS sought to foreclose upon the Maple Avenue property to satisfy three groups of tax liens: (1) tax liens that were reduced to judgment against Mr. Balice in 2008; (2) tax liens that were reduced to judgment in 2012; and (3) tax liens a that, by order accompanying the court's current opinion, were reduced to judgment against Mr. Balice. The court said that, because IRS had, either as the result of previous or current court orders, obtained judgment liens arising from the Balices' tax lien liability as to all tax liens, and because judgment liens are "effective, unless satisfied, for a period of 20 years" (28 U.S.C. §3201(c)), there was no issue as to the current enforceability of these three groups of liens.

As for the timeliness of IRS's action to collect taxes - i.e., the foreclosure claim - the 10-year statute of limitations under §6502 applied. Amboy argued that IRS's assessments made in 1994 and 2003 occurred over ten years ago, and that IRS was thus time-barred from asserting a foreclosure claim based on those liens. The court said that Amboy failed to appreciate that the time to collect taxes is extended "if a timely proceeding in court for the collection of a tax is commenced..." (§6502(a)) The court said that the current foreclosure proceeding commenced in 2014, more than ten years after 1994 and 2003. But the current proceeding was not the only relevant proceeding. The courts have interpreted "proceeding in court" in §6502(a) to include suits to reduce tax assessments to judgment. The 1994 and 2003 assessments were reduced to judgment, via "proceedings in court," in 2008 and 2012. Those proceedings were timely brought within the 10-year statute of limitations.

Bedrosian v. U.S., (DC PA 4/13/2017) 119 AFTR 2d ¶ 2017-678.

A district court has denied summary judgment to both IRS and a taxpayer in a case in which IRS imposed the maximum 50% penalty on the taxpayer for willfully failing to file a Report of Foreign Bank and Foreign Accounts (FBAR) with regard to his Swiss bank account. The court concluded that whether the taxpayer willfully failed to submit an accurate FBAR was an inherently factual question and that genuine disputes existed as to what the taxpayer knew about his reporting requirements and when he knew it.

Observation: *Bedrosian v. U.S.,* (DC PA 9/20/2017) 120 AFTR 2d ¶ 2017-5253, decided five months after the denial of summary judgement concluded that the taxpayer did not act willfully in a case in which IRS attempted to imposed the maximum 50% penalty on the taxpayer for failing to file an FBAR with regard to his Swiss bank account. Further, the court held that the amount that the taxpayer paid in partial satisfaction of his allegedly willful FBAR violation was illegally exacted from him, and, accordingly, IRS owed him that amount as a refund.

Each U.S. person who has a financial interest in or signature or other authority over any foreign financial accounts, including bank, securities, or other types of financial accounts in a foreign country, if the aggregate value of these financial accounts exceeds $10,000 at any time during the calendar year, must report that relationship each calendar year by filing an FBAR with the Department of the Treasury. The civil and criminal penalties for noncompliance with the FBAR filing requirements are significant. Civil penalties for a non-willful violation can range up to $10,000 per violation, and civil penalties for a willful violation can range up to the greater of $100,000 or 50% of the amount in the account at the time of the violation (these amounts are adjusted for inflation-for penalties assessed after August 1, 2016 whose associated violations occurred after November 2, 2015, the amounts are $12,459 and $124,588, respectively). Criminal penalties for violating the FBAR requirements while also violating certain other laws can range up to a $500,000 fine or 10 years imprisonment or both. Civil and criminal penalties may be imposed together. The authority to enforce these assessments has been delegated to IRS.

Arthur Bedrosian is a U.S. citizen who has had a successful career in the pharmaceutical industry over the past several decades, including as Chief Executive Officer at Lannett Company, Inc., a manufacturer and distributor of generic medications. In the early 1970s, he opened a savings account with a bank in Switzerland; at some point, at least as early as 2005, a second account was added.

Throughout the decades that Bedrosian maintained the Swiss accounts, he did not prepare his own tax returns and instead had his accountant do so. Bedrosian did not inform the accountant of the bank accounts until the 1990s, because, he stated, the accountant never asked about them. When informed, Bedrosian indicated that the accountant told him that he had been breaking the law for the past 20 years by not reporting the accounts. He also said that the damage was already done, that Bedrosian should do nothing, and that the issue would be resolved on Bedrosian's death when the assets in the Swiss accounts would be repatriated as part of his estate and taxes would be paid on them then. Based on this advice, as well as his fear that he would be penalized for his years of noncompliance, Bedrosian did not report either Swiss account on his tax returns until 2007, when the accountant died and he hired a new accountant.

Bedrosian filed a federal income tax return for 2007 that reflected, for the first time, that he had assets in a foreign financial account in Switzerland. He also filed a FBAR for the first time in 2007. But, he only reported the existence of one of his Swiss accounts (which had assets totaling approximately $240,000) and did not report the other account (which had assets totaling approximately $2.3 million). Bedrosian did not report any of the income that he earned on either Swiss account on his 2007 return.

Sometime after 2008, the Swiss bank told Bedrosian that it would be providing his account information to the U.S. government. Around this time, prior to the government's initiation of its investigation, Bedrosian hired an attorney to look into his reporting obligations for the Swiss accounts. In August 2010, he filed an amended 2007 federal return on which he reported the approximately $220,000 of income he had earned from the Swiss accounts; he also filed an amended FBAR for 2007, on which he reported both bank accounts. Although Bedrosian took this corrective action before the government began its audit, he did not do so until after IRS had discovered the existence of the two accounts.

IRS initiated its investigation of Bedrosian in April 2011, with a focus on tax year 2008. Beginning then, Bedrosian engaged with IRS cooperatively, providing them with all documentation requested. The investigation culminated in a case panel of IRS agents recommending that Bedrosian be penalized for nonwillful violations of the FBAR reporting requirement and that the case against him be closed. For reasons unclear in the record, the case was not closed but instead was re-assigned to another IRS agent, who conducted her own review and concluded that Bedrosian's violation had been willful.

On July 18, 2013, IRS sent Bedrosian a letter stating that it was imposing a penalty for his willful failure to file the FBAR form for tax year 2007. The proposed penalty was $975,789, 50% of the maximum value of the account ($1,951,578), the largest penalty possible under the regulations.

Bedrosian filed suit in the district court alleging illegal exaction, i.e., that an unwarranted penalty was imposed on him; IRS counterclaimed for full payment of the penalty, as well as accrued interest on the penalty, a late payment penalty, and other statutory additions to the penalty. Both parties sought summary judgment.

The district court denied both parties' request for summary judgment. It found that the key question was whether either party had pointed to a lack of genuine dispute of material fact on their claims. The answer was "no."

The court reasoned that the determinative issue for both Bedrosian's illegal exaction claim and the U.S.'s claim for payment of the proposed penalty was Bedrosian's intent. Whether he willfully failed to submit an accurate FBAR for 2007 was an inherently factual question and one that could not be resolved at this stage. Genuine disputes existed as to what Bedrosian knew regarding his reporting requirements and when he knew. This was especially true as these issues related to his relationship with his accountant.

Although the court acknowledged that there was no good cause exception for a willful violations of the FBAR filing requirement, the court nevertheless found that Bedrosian's testimony on the information provided to him by his first accountant and what exactly he did with that information, if anything, would be relevant to a determination of Bedrosian's intent.

While the district court noted that precisely what "willful" means in context of the FBAR civil penalty provision was not settled-with various federal courts, the Internal Revenue Manual, and the IRS Office of Chief Counsel reaching different conclusions about the level of intent necessary to satisfy the willfulness requirement-it concluded that it did not need to determine what the appropriate standard of willfulness was at this juncture in the case. However, the district court did note that the jurisprudential trend was towards one that would encompass reckless violations of the FBAR filing requirement. *U.S. v. Williams,* (CA 4 2012) 110 AFTR 2d 2012-5298, *U.S. v. Bohanec,* (DC CA 2016) 118 AFTR 2d 2016-6757, U.S. v. McBride, (DC UT 2012) 110 AFTR 2d 2012-6600 -all relying on the Supreme Court decision in *Safeco Ins. Co. of America v. Burr,* (S Ct 2007) 551 U.S. 47-stand for the proposition that a taxpayer has willfully violated the FBAR filing requirement not only when he knowingly violates the rule but also when he recklessly does so.

The district court further noted that Bedrosian did not reference Safeco in his arguments, but rather relied on two Supreme Court cases that examined willfulness in the criminal tax penalty context: *Cheek v. U.S.* (S Ct 1991) 67 AFTR 2d 91-344 and *Ratzlaf v. U.S.,* (S Ct 1994) 510 U.S. 135. Bedrosian argued that, as in the criminal cases, in a civil case, in order to sustain a willful penalty, the government must show that the taxpayer's actions amounted to "a voluntary, intentional violation of a known legal duty." The district court was highly skeptical that the Courts' reasoning in the criminal context would be applicable here.

Borenstein, (2017) 149 TC No. 10

Taxpayer, who did not file a timely return, was limited to the 2-year lookback period in §6511(a) and §6511(b)(2)(B), rather than the 3-year lookback period specified in the final sentence of §6512(b)(3). As a result, she was not entitled to a refund or credit of her overpayment.

If the Tax Court finds an overpayment instead of a deficiency, it can determine the amount of overpayment. Refund of an overpayment determined by the Tax Court is conditioned upon the Tax Court's including as a part of its decision a finding to the effect that the portion to be refunded was paid:

1. After IRS mailed the notice of deficiency; (§6512(b)(3)(A))

2. Within the look-back period which would be applicable under §6511(b)(2) (i.e., the regular period of three years after the return was filed or two years after payment), §6511(c) (the special period for extension agreements), or §6511(d) (the special period for bad debts, worthless securities, operating loss carrybacks, and foreign tax credits), if a refund claim, stating the grounds upon which the court finds an overpayment, had been filed on the date the deficiency notice was mailed. For purposes of this rule, it does not matter whether such a claim was actually filed; (§6512(b)(3)(B)) or

3. Within the applicable look-back period, in respect of a timely refund claim filed before the date of mailing the deficiency notice. However, this rule applies only if (a) the refund claim was not disallowed before the date of mailing the deficiency notice, or (b) if it was

> disallowed before that date, a timely refund suit could have been filed on that date, or (c) a refund suit had been filed before that date. (§6512(b)(3)(C))

Thus, the applicable look-back period set out in §6512(b)(3)(B) incorporates the general refund look-back period from §6511(b)(2) (the later of three years from the time the return was filed or two years from the time tax was paid), and directs the Tax Court to determine the applicable period by inquiring into the timeliness of a hypothetical claim for refund filed on the deficiency mailing date.

For claims for credit or refund for tax years ending after August 5, 1997, the Taxpayer Relief Act of 1997 (P.L. 105-34, 8/5/1997) amended former §6512(b)(3) (the Court referred to this amending provision as the "final sentence of I.R.C. sec. 6512(b)(3)") to provide that the look-back period is three years for obtaining a refund of overpaid taxes in the Tax Court under §6512(b)(3)(B), above) where a notice of deficiency is mailed during the third year after the due date (with extensions) for filing the tax return, and the taxpayer hadn't filed a return by the time the notice was mailed. Specifically, the 1997 amendment provides:

"In a case described in subparagraph (B) where the date of the mailing of the notice of deficiency is during the third year after the due date (with extensions) for filing the return of tax and no return was filed before such date, the applicable period under subsections (a) and (b)(2) of section 6511 shall be 3 years."

Roberta Borenstein's return for the 2012 tax year was originally due on April 15, 2013. She requested and received a 6-month extension of time to file that return. By virtue of that extension, the due date for filing her 2012 return was October 15, 2013.

Ms. Borenstein made tax payments for 2012 totaling $112,000. All of these payments were deemed made on April 15, 2013 under §6513. However, she did not file a return for 2012 by October 15, 2013, or during the ensuing 22 months.

On June 19, 2015, IRS issued Ms. Borenstein a notice of deficiency for 2012. On August 29, 2015, shortly before filing her Tax Court petition, she submitted a delinquent return for 2012 that reported a tax liability of $79,559. IRS and Ms. Borenstein agreed that for 2012 she had a tax liability of $79,559 and an overpayment of $32,441.

IRS contended that, under §6511(a) and §6511(b)(2)(B), Ms. Borenstein was not entitled to a credit or refund of the overpayment because her tax payments were made outside the applicable lookback period keyed to the date on which the notice of deficiency was mailed.

On the other hand, Ms. Borenstein contended that she was eligible for the 3-year lookback period specified in the final sentence of §6512(b)(3) and that she was entitled to a refund of $32,441 under that provision.

The Tax Court determined that Ms. Borenstein was not eligible for the 3-year lookback period specified in the final sentence of §6512(b)(3) because the notice of deficiency was not mailed to her "during the third year after the due date (with extensions) for filing the return of tax."

The Court further held that Ms. Borenstein did not file her 2012 income tax return before the notice of deficiency was issued and did not pay her tax liability within two years of the mailing of the notice of deficiency. Accordingly, the Tax Court lacked jurisdiction to award a refund or credit of her $32,441 overpayment for 2012.

Noting that this case was one of first impression because it was the first time the Tax Court had been called upon to interpret the final sentence of §6512(b)(3), the Court accepted IRS's "plain language" interpretation that, in the final sentence, the parenthetical phrase "with extensions" modifies "due date." Here, the "due date (with extensions) for filing the return of tax" was October 15, 2013, pursuant to the automatic extension Ms. Borenstein received to file her 2012 return. The "third year" after that date began on October 15, 2015. But the notice of deficiency was mailed on June 19, 2015. That date was during the second year, not during the third year, "after the due date (with extensions) for filing the return," as the 1997 amendment required. So, the exception set out in the final sentence of §6512(b)(3) did not apply, with the result that a refund or credit of her $32,411 overpayment was barred by the 2-year lookback rule generally applicable to non-filers.

Rejecting the taxpayer's contentions, the Court found that the legislative history of the 1997 amendment did not have the force that Ms. Borenstein attributed to it. Contrary to the taxpayer's view, the legislative history did not establish congressional intent that all non-filers be treated identically "during the three-year period following the initial due dates of their returns." Nor did it establish intent that all non-filers be treated the same, without regard to whether they secured extensions of time to file.

The Court reasoned that, although a plain language interpretation of the final sentence of §6512(b)(3) produced an odd result in certain factual circumstances, it did not render the operation of the statutory amendment as a whole "absurd." Rather, because of what seemed inartful drafting, it had one or more gaps in coverage. However, the Court concluded that, as has often been said, courts should not attempt to fill statutory gaps in order to fashion judicial remedies. The text enacted by Congress made syntactic sense and had an unambiguous meaning. Construing that text according to its plain meaning did not produce a result "so gross as to shock the general moral or common sense."

Byrne, (CA 6 5/15/2017) 119 AFTR 2d ¶ 2017-762.

The Court of Appeals for the Sixth Circuit, vacating and remanding a district court decision that held corporate officers liable for the §6672(a) trust fund penalty, has held that the officers took reasonable steps to ensure the timely payment of trust fund taxes and reasonably believed that the taxes were being paid. The Court also ruled on the standard of review to be applied by Circuit Courts when they determine whether a taxpayer acted willfully under §6672(a).

Under §6672(a), if an employer fails to properly pay over its payroll taxes, IRS can seek to collect a trust fund penalty equal to 100% of the unpaid taxes from a person who: (1) is a "responsible person"-i.e., one who is responsible for collecting, accounting for, and paying over payroll taxes; and (2) willfully fails to perform this responsibility.

The Sixth Circuit has previously held that a responsible person will be found liable under §6672(a) if the government can demonstrate that he or she had either (1) actual knowledge that the trust fund taxes were not paid and the ability to pay the taxes, or (2) recklessly disregarded known risks that the trust fund taxes were not paid. In other words, for a responsible person to be deemed to have acted willfully under §6672(a), he or she must have either "had knowledge of the tax delinquency and knowingly failed to rectify it when there were available funds to pay the government" (*Gephart,* (CA 6 1987) 59 AFTR 2d 87-1099) or "deliberately or recklessly disregarded facts and known risks that the taxes were not being paid." (*Calderone,* (CA 6 1986) 58 AFTR 2d 86-5703)

Circuit Courts review trial court findings of fact for clear error and their conclusions of law de novo in an appeal from a judgment entered after a bench trial. *(T. Marzetti Co. v. Roskam Baking Co.,* (CA 6 2012) 680 F.3d 629; Fed. R. Civ. P. 52(a)(6)) Circuit Courts also review de novo "ultimate facts" and mixed questions of law and fact. (*Williams v. Mehra,* (CA 6 1999) 186 F.3d 685) Ultimate facts are conclusions of fact which are logically deduced from evidence, i.e., from evidentiary facts.

Eagle Trim was an automotive supplier. Its largest client was General Motors and it was largely financed by General Motors Acceptance Corporation (GMAC). The parties relevant to this case were Roger Byrne (1.5% owner; President/General Manager/Board Member), Eric Kus (40% owner; Chairman/CEO/Board Member), and Bernard Fuller (Controller).

Both Byrne and Kus had the ability to hire and fire employees, as well as signature authority on all then-existing Eagle Trim bank accounts. Fuller handled the filing and payment of employee trust fund taxes.

Eagle Trim hired the CPA firm of Weber, Curtin & Drake, PC (WCD) to conduct its year-end audits and to prepare Eagle Trim's corporate income tax returns.

In 1999, IRS assessed a $30,000 penalty against Eagle Trim for paying its payroll taxes biweekly instead of weekly.

In March 2000, WCD sent a letter to Kus, copying Byrne and Fuller, advising Eagle Trim of deficits in its accounting practices, which WCD had observed while conducting its 1999 audit. The letter also stated, however, that WCD's observations did not discover any "material weaknesses." WCD recommended in its letter that Eagle Trim hire an assistant controller with an accounting degree.

Pursuant to WCD's recommendation, in April 2000, Eagle Trim hired Kelly Gillman, an accountant, to assist Fuller with his duties as controller. In July 2000, Eagle Trim also hired Andrew Jones as Eagle Trim's chief financial officer. Jones reported to both Byrne and Kus on all of the financial aspects of Eagle Trim. Fuller reported to Jones.

In October 2000, IRS sent Eagle Trim a notice of a penalty for unpaid trust fund taxes for the first quarter of 2000. David Drake, a WCD partner, met with Fuller to discuss the penalty. Fuller informed Drake that he had failed to pay the trust fund taxes on time because of difficulties associated with Eagle Trim's change to a new bank. Following his conversation with Fuller, Drake sent a letter to IRS, repeating Fuller's explanation for the late trust fund tax deposit and requesting that IRS waive the penalties. On November 10, 2000, Fuller sent a letter to Kus, Byrne, and Jones, describing the IRS penalty, his meeting with Drake, and Drake's request for an abatement of the penalty.

WCD issued a "clean" audit on December 11, 2000, regarding Eagle Trim's financial statements through September 30, 2000, opining that the financial statements presented Eagle Trim's financial position fairly in all material respects. The report found that Eagle Trim was current in the payment of trust fund taxes. Despite WCD's clean audit report, in January 2001, WCD sent a letter to Kus, copying Byrne, Jones, and Fuller, identifying flaws in Eagle Trim's accounting practices observed by WCD in the course of its 2000 audit. The letter included a section devoted to Eagle Trim's failure to pay trust fund taxes in a timely manner in 1999 and the first quarter of 2000.

Also in January 2001, one of Eagle Trim's lenders discovered that Eagle Trim's financial statements were fraudulently overstated and the company, rather than being profitable, was losing money. Fuller had greatly overstated the company's receivables. Eagle Trim entered into a "Forbearance Agreement" with GMAC, dated January 31, 2001, under which GMAC hired a crisis management company, BBK, Ltd. (BBK) to manage Eagle Trim.

At the time the Forbearance Agreement was executed, Kus and Byrne were unaware that Eagle Trim was delinquent on trust fund taxes for the second, third, and fourth quarters of 2000. In late February 2001, BBK informed Byrne and Kus that Eagle Trim was delinquent on its trust fund tax deposits for those quarters.

On March 1, 2001, WCD sent a letter to Byrne explaining that WCD was recalling its audit reports due to the discovery of Fuller's fraud.

Eagle Trim went into bankruptcy in April 2001. Via the bankruptcy proceeding, IRS was paid for the previously unpaid trust fund taxes for the second quarter of 2000.

IRS assessed against Byrne and Kus §6672(a) penalties for the third and fourth quarters of 2000. The officers brought suit in district court. The district court found that Byrne and Kus willfully failed to pay Eagle Trim's trust fund taxes for the third and fourth quarters of 2000 and were therefore liable under §6672(a). Byrne and Kus appealed to the Sixth Circuit.

The Circuit Court concluded that willfulness under §6672(a) is an ultimate fact and therefore reviewed de novo the district court's holding that Byrne and Kus willfully failed to pay Eagle Trim's trust fund taxes. It said that which standard of review applies to the district court's determination that a responsible person willfully failed to pay trust fund taxes was a question of first impression in the Sixth Circuit Court. And it said, while it acknowledged that at least one other circuit had held that the determination of willfulness under §6672(a) is a question of fact-i.e., *Wright*, (CA 7 1987) 59 AFTR 2d 87-467 -it believed that, at least in this context, willfulness is a question of ultimate fact because finding that someone was willful requires the application of a legal standard to underlying facts. Byrne and Kus did not challenge the district court's factual findings regarding their conduct; they challenged whether this conduct satisfied the legal standard of willfulness.

The officers acted reasonably and therefore did not willfully fail to pay. The Circuit Court held that Byrne and Kus took reasonable steps to ensure the timely payment of the third and fourth quarter 2000 trust fund taxes, that they reasonably believed that the taxes were being paid, and thus that they did not willfully fail to pay the payroll taxes.

The Court said that the district court correctly determined that Byrne and Kus did not have actual knowledge that the trust fund taxes were not being paid. The record indicated that Byrne and Kus did not acquire actual knowledge of the delinquency until after the Forbearance Agreement was executed and BBK assumed control of Eagle Trim's finances.

The district court's finding that they were reckless largely turned on the reasonableness of their reliance on WCD's guidance and audits. The Circuit Court disagreed with the district court that Byrne and Kus did not demonstrate by a preponderance of the evidence that they reasonably believed that Eagle Trim's trust fund taxes for the third and fourth quarters of 2000 were being paid.

The Court said that what constitutes reckless disregard for purposes of §6672(a) is an issue of first impression for the Sixth Circuit Court. It then reviewed the precedents of other circuits. It reiterated its previous holding in *Calderone* that a responsible person is reckless and therefore willful under §6672(a) when he or she disregards obvious or known risks that trust fund taxes are not being paid to IRS and fails to investigate. "However, we must balance the government's prerogative to recover that which is owed with limiting liability for that recovery to those who are personally at fault." While noting that §6672(a) does not have a reasonable cause exception, it adopted the Second Circuit's "reasonable cause" exception to §6672(a) liability: "a responsible person's failure to cause the withholding taxes to be paid is not willful if he believed that the taxes were being paid, so long as that belief was, in the circumstances, a reasonable one." (*Winter,* (CA 2 1999) 84 AFTR 2d 99-6892)

The Circuit Court said that the district court held that Byrne and Kus could not rely on WCD to verify that Fuller had become a responsible taxpayer without making any inquiry into what WCD actually did to review his performance of his payroll tax duties. In support of its conclusion, the district court cited Drake's deposition testimony that, when he drafted the October 2000 letter to IRS concerning the penalty for the first quarter of 2000, he had done nothing to verify Fuller's account of the late payments.

The Court said that it is certainly true that Byrne and Kus could have taken any number of additional steps to ascertain the status of Eagle Trim's trust fund tax liability. However, it said, its inquiry was limited to whether their belief that trust fund taxes were being timely paid was reasonable under the circumstances. "We will not impose liability on Byrne and Kus simply because they did not independently verify their auditors' reports or Fuller's account of the status of Eagle Trim's tax position." For the reasons stated below, the Court determined that Byrne and Kus took reasonable steps to ensure the timely payment of trust fund taxes and reasonably believed that the taxes were being paid.

First, they hired Gillman and Jones to assist and supervise Fuller, respectively. The Court said that, while it was not holding that responsible persons may escape liability under §6672(a) simply because they hired support staff or other officers to review payment of trust fund taxes, these were important considerations in determining whether Byrne and Kus reasonably believed Eagle Trim was making timely payment of trust fund taxes.

Second, Byrne and Kus's hiring of WCD-an independent, professional accounting firm-to assist in tax matters and conduct annual, full-scope audits further demonstrates that they took reasonable steps to comply with all of Eagle Trim's legal tax obligations, including the timely payment of trust fund taxes. According to the district court, because Drake did not say in his October 2000 letter whether he investigated Fuller's story, Byrne and Kus could not reasonably have relied on this letter. That is, the district court's logic was that Byrne and Kus could not reasonably rely on any of WCD's statements after notice of Fuller's prior failures to pay the trust fund taxes on time. The Circuit Court said that, because Byrne and Kus had no prior indication of errors or inaccuracies in WCD's auditing, the Court held that their reliance on WCD's representations was reasonable.

Third, while WCD noted in its December 2000 audit report that Eagle Trim had been delinquent in paying its trust fund taxes for the first quarter of 2000, WCD confirmed that Eagle Trim's financial statements were fairly presented in conformity with generally accepted accounting principles. Of course, in March 2001, WCD withdrew its December 2000 audit report following the discovery in January 2001 of Fuller's fraud. Thus, even licensed CPAs, who had performed a full-scope audit, missed Fuller's inaccurate accounting entries. And BBK noted that it took several months to gain an understanding of the full amount of the tax liability.

The Court said that it could not say that Byrne and Kus acted unreasonably or held an unreasonable belief that Fuller had begun to pay the trust fund taxes on time, given that WCD, a CPA firm, did not detect Fuller's suspect financial accounting after having performed a full-scope audit and that it took several months for a crisis management firm to determine the exact amount of Eagle Trim's tax liability.

The Circuit Court vacated the district court's opinion and remanded for further proceedings not inconsistent with the Circuit Court opinion.

In re: William R. Canada, Jr., (DC TX 05/08/2017) 119 AFTR 2d ¶2017-740.

A district court, affirming the bankruptcy court, has held that a Chapter 11 debtor was not liable for over $40 million in penalties for failing to register a tax shelter because, under the law in effect at that time, the transactions at issue were not considered tax shelters. The district court also affirmed the bankruptcy court's decision that, even if the transactions were tax shelters, the debtor had reasonable cause for failing to register them based on the fact that he conducted research into what was a legitimately unclear and not well-developed area of law.

Former §6111(a), as in effect during the years at issue in this case, provided that any tax shelter organizer had to register the tax shelter with IRS no later than the day on which the first offering for sale of interests in such tax shelter occurs. Former §6111(c) provided a highly technical definition of "tax shelter," including a threshold requirement that the suspect transaction be an "investment." An alternative definition of "tax shelter" was provided in former §6111(d); it broadly included entities, plans, arrangements, and transactions structured to avoid taxes that are offered under conditions of confidentiality.

Under former §6707, as in effect during the years at issue in this case, a person who was required but failed to register a tax shelter under former Code Secs. 6111(a) and (c) had to pay a penalty equal to the greater of 1% of the aggregate amount invested in the tax shelter or $500. However, under former §6707(a)(1), any failure to register due to reasonable cause did not result in a penalty.

In 2004, after the years at issue in this case, both of the above provisions were, as described by the court, "revised from the ground up" such that the "potential realm of reporting requirements under the current version...sweeps far broader than it did under the version of the statute that was effective during the Relevant Time Period." Similarly, the reasonable cause exception was modified to make it much harder for a taxpayer subject to the revised provisions to qualify for its relief.

William Canada is a Harvard law school graduate who, before coming to work at Heritage Organization, LLC in 1995, worked at a variety of law firms primarily as a commercial litigator. Canada had done some employment litigation work for Gary Kornman, Heritage's main principal, who hired Canada as a contractor-i.e., to meet with prospective clients in order to interest them in Heritage's services, including the "Heritage Transactions" that are the subject of the case. By 1998, Canada was a key player at Heritage who was heavily involved in the marketing and sale of the Heritage Transactions to clients. Canada later became Heritage's President and/or Chief Operating Officer, but he claimed that Kornman was always the person who was truly in control of Heritage.

The Heritage Transactions were first marketed in 1998 as a way to generate capital losses and reduce Heritage clients' capital gains taxes. The particular Heritage Transactions for which IRS sought to impose penalties on Canada occurred between 1998 and 2001. The Heritage Transactions were not marketed as shares of a particular partnership entity or services of a particular law firm, but rather were sold as a little-known tax-saving strategy.

Canada left Heritage in 2002 over a compensation-related dispute with Kornman and won an arbitration award of over $6 million related to this dispute in April 2004. Shortly thereafter, in May 2004, Heritage filed for Chapter 11 bankruptcy, and Canada actively participated in order to collect his arbitration award. A plan of reorganization was confirmed on September 12, 2007.

Canada received a letter dated February 12, 2007 from IRS informing him that it was investigating him for possible liability for penalties under former §6707, then informed him over eight years later that it intended to impose over $40 million in penalties against him as a result of his actions as a Heritage employee. Canada filed his voluntary petition under Chapter 11 on September 9, 2015. IRS filed a claim for the penalties to which Canada objected.

The bankruptcy court found that the Heritage Transactions were not an "investment." Accordingly, the Transactions were not a tax shelter within the meaning of former §6111(c) and so did not subject Canada to penalties under former §6707 for failure to register a tax shelter. The Heritage Transactions were not a revenue-producing asset or share of a business entity or something else that would typically be considered an investment, but rather were strategies to be employed in order to generate tax benefits. (*In re: William R. Canada, Jr.,* (Bktcy Ct TX 06/07/2016) 117 AFTR 2d ¶2016-758)

The court also found that, in addition to the fact that the Heritage Transactions were not covered by the plain meaning of an "investment," a statutory interpretation principle supported this finding-the "no surplusage" canon that "a statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant." (*Corley v. U.S.,* (Sup Ct 2009) 556 U.S. 303) Here, former §6111 contained two distinct definitions of a tax shelter in sections (c) and (d). While the definition in (d) (which applied to certain confidential arrangements) included "any entity, plan, arrangement, or transaction," which would encompass the Heritage Transactions, the definition in (c) (which was the definition that actually applied in this case) did not, and interpreting it as IRS argued would violate the no surplusage canon.

Despite its foregoing, dispositive conclusion, the court also concluded that Canada would not have been subject to penalty under former §6707 because he established reasonable cause for his failure to register the Transactions. The court looked at what constitutes reasonable cause for purposes of accuracy-related penalties under §6662, citing regulations stating that "[c]ircumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer." (Regulation §1.6664-4(b)(1)) The court also cited one case holding that it was "inappropriate to penalize taxpayers where a mistake of law was [made] in a complicated subject area without clear guidance." (*Shao,* TC Memo 2010-189) The court also cited a case involving a highly educated taxpayer who reached a position that, while legally incorrect, was sound from a financial and economic viewpoint (which was the taxpayer's area of expertise), for the counter intuitive proposition that a taxpayer's high level of sophistication can make a mistake of law more reasonable. (*Svboda,* TC Memo 2006-235) Cases involving undeveloped areas of law-especially, like this, a case of first impression-are "prime candidates" for reasonable cause, the court observed.

The court found that, although Canada's reliance on the legal advice of the attorney who initially conceived of the Heritage Transactions that former §6111 did not apply was not sufficient (due to a conflict of interest), this advice, in combination with his own examination of possible reporting obligations, the lack of an obvious way to fit the Heritage Transactions into the statutory framework of former §6111, and the lack of authority interpreting that statute, did show reasonable cause. Reasonable cause was further shown by the fact that the court itself ultimately agreed with the conclusion reached by Canada that former §6111 did not apply, and even the IRS agent who testified admitted that the Heritage Transactions "did not fit the typical mold of what would normally be considered" an investment.

The district court affirmed the determination of the bankruptcy court that the Heritage Transactions were not "tax shelters" subject to registration because they were not "investments." The district court concluded that the plain meaning of the word "investment" simply did not appear to encompass the Heritage Transactions. Nor did the usual canons of statutory construction or the legislative history, or even IRS's own temporary regulation (former Regulation 301.6111-1T), indicate that Congress intended otherwise here.

The district court noted that the implementation of the Heritage Transactions through the funding of brokerage accounts, the purchase of treasury securities, and setting up entities certainly involved "investments" of various types. However, the Heritage Transactions were not themselves "investments." While the Transactions certainly contemplated the use of "investments" to implement the Heritage strategy, the Heritage Transaction itself was simply that: a strategy. Heritage did not sell the client the Treasury securities or the business entities to implement the strategy. It merely gave the client the idea.

The court found that the Heritage Transactions simply did not appear to fit within any commonly understood definition of the word "investment": Heritage did not offer for sale to, or purchase on behalf of, its clients any share or interest in any corporation, entity, or stock in the traditional sense. What it sold was a strategy, composed of a series of prescribed steps or transactions, to reduce capital gains taxes. Though it was not totally clear from the record to what extent Heritage oversaw or facilitated the transactions, it was clear that the purchase and sale of Treasury securities were accomplished through independent, national brokerage houses. All that clients purchased from Heritage was the idea.

In its statutory analysis, the court noted that former §6111(d) explicitly encompassed an "entity, plan, arrangement, or transaction"; but it did not use the term "investment." On the other hand, former §6111(c) (defining a "tax shelter" for general purposes) made no mention of "entities," "plans," "arrangements," or "transactions. Rejecting IRS's contention that the difference between the two sections was not intentional-and so an "investment" should be interpreted as including a "transaction"-the court refused to ignore the accepted canon of construction which advised that the difference in language was intentional. That rule applied particularly here, where former §6111(c) and (d) were enacted at different times and for different purposes.

The court also rejected IRS's contention that the bankruptcy court erred by not giving deference to former Regulation §301.6111-1T, A-22, which the court found did not provide an official agency interpretation of the term "investment," as IRS argued, but rather provided rules for the aggregation of similar investments offered by the same person or persons. If any question and answer in the regulations was arguably relevant to the issue at hand, the court found that it would seem to be former Regulation §301.6111-1T, Q-4, which asked: "What investments are tax shelters that are required to be registered with the Internal Revenue Service?" However, as the answer to this question made no mention of a "plan," "arrangement," or "transaction," it was hardly helpful to IRS's argument that the "investment" should be included within the term "transaction."

The district court also found that, considering the specific facts and circumstances of the case, and given the complexity of the statutes in question, the lack of any clear existing authority, and Canada's own investigation into his registration responsibilities, it would be unfair to penalize Canada for what appears to have been an honest mistake of law based on his reasonable, good faith effort to comply. The court held that the bankruptcy court did not err, and certainly not clearly so, in finding that Canada established "reasonable cause" for failing to register the Heritage Transactions as tax shelters.

The district court noted that legal "reliance"-as in "reliance on the advice of a tax professional"-was not the same as Canada's "reliance" on his own investigation of his registration responsibilities. Although Canada was not a tax attorney and had admittedly "very little" pure tax experience before joining the Heritage Organization, he was still a Harvard-trained lawyer with over 15 years of experience in commercial litigation, not to mention several years working in estate-planning-based insurance products while at Heritage. He read virtually the only authorities in existence at the time the statute and its corresponding regulations) and determined that they did not apply, a conclusion with which both the bankruptcy court and the district court agreed. While IRS lamented that Canada consulted only these authorities in assessing his responsibilities, the district court noted that they appeared to have been the only authorities that were available.

Cardaci, (CA 3 5/8/2017) 119 AFTR 2d ¶ 2017-736.

The Court of Appeals for the Third Circuit has affirmed a district court's decision that a delinquent taxpayer's home that he owned as tenants by the entirety with his wife was property subject to a federal tax lien. But it vacated and remanded the lower court's decisions to not order a sale of that home but instead have the taxpayer pay ''rent'' on the property to pay off his tax liability.

A federal tax assessment against a person automatically creates "a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person." (§6321) IRS may bring a lien foreclosure suit under §7403, i.e., an action in federal district court, to reach the funds.

The Supreme Court, in *U.S. v. Rodgers,* (S Ct 1983) 52 AFTR 2d 83-5042, held that §7403 empowers a district court to enforce a tax lien by decreeing a forced sale of an entire property in which a delinquent taxpayer has an interest, even though a nondelinquent person also has an interest in the same property. The nondelinquent person is entitled to receive an appropriate portion of the sales proceeds. Under certain circumstances, the district court may use its discretion to disallow a request for the forced sale. This discretion should be exercised in the light of the following considerations:

a. The extent to which government financial interests would be prejudiced by relegating it to a forced sale of the partial interest;

b. Whether an innocent/nondelinquent third-party has a legitimate or legal expectation that his separate interest would not be subject to a forced sale by the delinquent taxpayer or his creditors;

c. The likely prejudice to the third party, both in personal dislocation costs and in practical undercompensation; and

d. The relative character and value of the nonliable and liable interests held in the property.

The taxpayers were Mr. and Mrs. Cardaci. Mr. Cardaci was the owner of a business that folded; he owed $80,000 of unpaid taxes, interest and penalty with respect to the business.

Mr. and Mrs. Cardaci owned their residence in New Jersey as tenants by the entirety. It had a market value in the neighborhood of $150,000; there was no mortgage on the property.

IRS brought an action to reduce to judgment the federal tax assessments against Mr. Cardaci and to force the sale of the Cardaci home. It sought to collect half of the proceeds to pay for Mr. Cardaci's tax liability and to distribute the remainder to Mrs. Cardaci. The district court, recognizing that Mr. Cardaci owed $80,000 and that IRS had a valid lien on the Cardaci residence, granted partial summary judgment to that effect.

The district court held a trial with respect to the issue of the forced sale. It issued a judgment, based on its consideration of the equitable factors set out in Rodgers, that "the equities of this case warrant the exercise of the court's very limited discretion not to order a sale." It therefore fixed an imputed monthly rental value of $1,500 for the property and ordered Mr. Cardaci to pay half of that value to IRS each month.

At the time of the district court's order, Mr. Cardaci was age 58, and Mrs. Cardaci was 62.

Mr. Cardaci defaulted on his monthly payment obligations. Both parties filed timely appeals.

The Circuit Court, affirming the district court, rejected the taxpayers' argument that their home was not subject to a foreclosure sale because it was protected by a New Jersey statute.

Besides determining that the New Jersey statute did not apply to the Cardacis because it only affected tenancies by the entirety that were created after the Cardacis' tenancy was created, the Court said that, regardless of the applicability of New Jersey statutory or common law, state law must give way to the supremacy of federal law. The Court cited the Supreme Court in *Craft,* (S Ct 2002) 89

AFTR 2d 2002-2005, for the principle that "state law determines only which sticks are in a person's bundle of property rights. Whether those sticks qualify as 'property' for purposes of the federal tax lien statute is a question of federal law." And it said that "State-created exemptions are swept aside by the Supremacy Clause of the Constitution."

IRS argued that the district court abused its discretion in analyzing the Rodgers factors and then erred in concluding that the Cardacis' home should not be sold. The Circuit Court agreed that the district court erred in its analysis of the Rodgers factors but declined to reweigh the factors itself. Instead, it remanded for the district court to recalculate Mr. and Mrs. Cardacis' relative property interests and again engage in a thorough analysis of the equitable factors set forth in Rodgers.

The Court made the following observations regarding the Rodgers factors:

1. **The prejudice to the government resulting from a partial sale.** The district court concluded that this factor weighed in IRS's favor "only slightly" because a sale of Mr. Cardaci's interest would provide little value, while requiring Mr. Cardaci to pay rental payments to IRS was "likely to produce much greater collection of taxes to IRS compared with the amount likely to be obtained from a foreclosure sale of the entire property."

   The Circuit Court agreed with that evaluation of what might be gained by trying to sell Mr. Cardaci's interest in the home, but taking into account what might be gained from rental payments was not a sound approach in considering this factor. The focus should solely be on determining whether the government would be adequately compensated by a partial sale of the taxpayer's interest or whether a sale of the entire property is necessary to vindicate the government's interest.

   An analysis of this factor boils down to the idea that, "the higher the expected market price of a partial interest, the less the prejudice, and the less weighty the government's interest in going ahead with a sale of the entire property." Because there is no real market for one spouse's interest in a marital home held in a tenancy by the entirety (the sale of which would leave the purchaser as a tenant in common with the remaining spouse), the Circuit Court said that this factor weighed in favor of a forced sale of the Cardaci home.

2. **The non-liable party's legally recognized expectation in the property.** The Court here said that consideration of that expectation requires reference to the protections afforded by state law. The district court found that, because New Jersey law provides special protection for a spouse's interest in marital property, Mrs. Cardaci would have expected that her property would be free from foreclosure based on her husband's tax obligations. According to IRS, however, when the district court looked to New Jersey state law, it relied upon a statute that was "facially inapplicable."

   The Circuit Court agreed with IRS. In determining the effect of New Jersey law on Mrs. Cardaci's expectations, the district court relied, in part, as noted above, on a section of New Jersey's statutory code that only applied to tenancies by the entirety created after the Cardacis' tenancy was created. Therefore, the Circuit Court said, IRS was correct that that statute was inapplicable and, on remand, the district court should consider the issue under common-law principles without reference to the statute.

3. **The likely prejudice to the third party**. The district court concluded that this factor was neutral because, while Mrs. Cardaci would face dislocation costs, the costs were no greater than in any other foreclosure sale.

> The Circuit Court agreed that there were no special dislocation costs to consider here. But it found problematic that the district court did not then address the "practical undercompensation" Mrs. Cardaci might suffer in the event of a forced sale.

In order to determine whether an innocent spouse will be adequately compensated by a fair distribution of the proceeds from a forced sale, a court must first determine the amount that the spouse would receive from such a sale. The district court here said Mrs. Cardaci's interest in the property was worth 86% of the property's market value, determined as follows: The Cardacis' survivorship rights were of equal value: 50% of the property. It then found Mrs. Cardaci's life estate to be worth 72% of the value of her interest in the property. Because Mrs. Cardaci had only a one-half interest in the property, that 72% was divided by two to get to 36% of the value of the whole property. Since Mrs. Cardaci also had a 50% interest in survivorship, the Court added that 50% to the 36% value of the life estate to find that she had an 86% total interest in the value of the property. The district court did not include Mr. Cardaci's interest in a life estate in its calculations; the Circuit Court noted that had the district court done so, the sum of both spouses' interests would have exceeded 100%.

IRS argued that, based on the decision in *Popky v. United States,* (CA 3 2005) 419 F.3d 242, the district court should have determined that each spouse had a 50% interest in the home, without any consideration of their respective life expectancies and future interests in the home.

The Circuit Court said that neither position was correct.

Popky was not controlling. In that case, the marital property at issue had already been liquidated. The Popky Court concluded that the interest of each spouse in the resulting cash was an equal 50%. Even though the cash itself was still held by the spouses as tenants by the entireties under the controlling state law, there can be no life estate in cash as there can in real property. As a result, there was no need in Popky to turn to actuarial tables.

As to the district court's calculation of the Cardacis' respective interests in the marital home, the Circuit Court said that, in a tenancy by the entirety, each spouse has a concurrent interest in the present value of the property, in a life estate, and in a right of survivorship. But because both the probability of obtaining the property upon the death of one's spouse and the value of the life estate depend on life expectancy, any calculation of the cash value of those interests must be based on actuarial statistics. To give one admittedly extreme example, the Court said, it stands to reason that a healthy 26-year-old wife would have a greater interest in a life estate than would her ailing 89-year-old husband. While each spouse would have the same rights to the home, the measurable property value that they would be likely to receive from the property is not the same. Therefore, a method of calculation was needed that took into account each spouse's concurrent interest in the present value and their varying interests in life estate and survivorship rights.

A fair approach must therefore rely on joint-life actuarial tables to reflect the interests of both spouses. And, such an approach avoids the dilemma created by the district court's methodology, which resulted in a sum of the various interests that exceeded 100% of the value of the property.

The Circuit Court said that the Cardacis owned approximately equivalent interests in the property, both in terms of the character and value of their interests. Therefore, the fourth factor seemed neutral. Once the district court calculated the relative interests in the property using a joint-life actuarial table, it would be in a position to determine more precisely how this fourth factor weighs in the balance.

Chan, (CA 10 5/30/2017) 119 AFTR 2d ¶ 2017-803.

The Court of Appeals for the Tenth Circuit has affirmed a district court's opinion that a taxpayer did not file a timely refund claim; it based its decision on, among other reasons, its holding that he did not meet §6511(h) 's requirements for being financially disabled. The Court also held, disagreeing with the district court, that §6511(a) 's rule, that a refund claim is timely if it is filed within three years after filing the tax return, applies whether or not the tax return was timely filed.

In general, a taxpayer must file a claim for credit or refund of tax within three years after filing the return or two years after paying the tax, whichever period expires later. (§6511(a)) §6511(b) limits the amount of a claimed credit or refund of an overpayment to the tax paid within the period, immediately preceding the filing of the claim, equal to three years plus the period of any extension.

The periods of limitation under §6511(a) and §6511(b) are suspended for any period of an individual taxpayer's life during which he is financially disabled. (§6511(h)(1))

An individual is financially disabled if he is unable to manage his financial affairs because of a medically determinable mental or physical impairment that can be expected to result in death, or has lasted (or can be expected to last) for a continuous period of not less than 12 months. But an individual is not considered to have a financially disabling impairment unless proof of the existence thereof is furnished in such form and manner as IRS may require. (§6511(h)(2)(A)) IRS requires that a physician's statement containing specified information be submitted with a refund claim in order to claim financial disability. (Revenue Procedure 99-21, 1999-17 IRB 18)

As a prerequisite for suing IRS for a refund, taxpayers must have filed a timely claim for refund with IRS. (§7422(a))

The record did not show when the taxpayer, Mr. Chan, paid his 2008 income taxes. His 2008 return was due on April 15, 2009, but according to Chan, he applied for a 6-month extension and filed a timely return on October 15, 2009. He subsequently filed two refund claims, the first on October 15, 2012, and the second on April 15, 2013. Thus, Chan filed his first refund claim exactly three years after he filed his return.

IRS refused the claims. Chan sued in district court. IRS moved to dismiss, arguing that the district court lacked subject matter jurisdiction because Chan did not file a timely refund claim under §6511. Chan argued that he was financially disabled "from 2008 to 2016," but the district court never addressed that issue. The district court agreed with IRS and dismissed the case. (*Chan,* (DC UT 2016) 118 AFTR 2d 2016-5622)

The Circuit Court found that the claims were not timely and therefore affirmed the district court's dismissal of the case.

But first, it pointed out its disagreement with a finding by the district court. The district court found that the first claim was untimely under §6511(a). It based this finding on the fact that Chan had failed to show he actually applied for an extension, so his return was late.

The Court here disagreed with this analysis. It said that nothing in the language of §6511(a) suggests a return must be timely to trigger the 3-year limitation period for filing a refund claim, and courts have almost unanimously held otherwise. "Under §6511(a), a taxpayer's claim for credit or a refund is timely if it is filed within three years from the date his income tax return is filed, regardless of when the return is filed." Because Chan filed his first refund claim within three years after filing his 2008 tax return, that claim was timely under §6511(a) whether or not he applied for an extension.

However, even when a taxpayer files a refund claim within §6511(a) 's 3-year period, §6511(b)(2)(A) limits the amount of any refund to the portion of the tax paid in the three years prior to the claim, plus any extension for filing the return. Chan never alleged that he paid any tax between April 15, 2009 and April 15, 2013, so his first refund claim resulted in no refund under §6511(b).

And, the Court said, his second claim was untimely under §6511(a).

The Court then took up the "financially disabled" issue. Chan alleged in his complaint that he submitted "a physician's statement proving financial disability" with his April 15, 2013 refund claim. But he did not describe the contents of the statement or argue that it met the Revenue Procedure 99-21 requirements, and the Court held that his allegations were insufficient to show financial disability. In the Circuit Court, Chan argued that he "ha[d] enhanced evidence for claiming financial disability," but the Court here said that "the district court [could] not make a determination of financial disability if he did not first provide the requisite proof to the IRS."

Conrad, TC Memo 2017-116.

Where a taxpayer's first husband employed an unscrupulous accountant who prepared totally fictionalized partnership returns showing the couple as the partners and showing large losses, and who continued to prepare such returns after the first husband's death and the taxpayer's marriage to her second husband, the taxpayer was liable for the resulting tax deficiency and accuracy-related penalty, and was not entitled to any of the three forms of spousal relief, with respect to a year in which she was married to the second husband.

The §6662(a) penalty, also known as the accuracy-related penalty, is a 20% penalty on an underpayment of tax attributable to any of the causes listed in §6662(b). However, the penalty does not apply to the portion of an underpayment for which the taxpayer has reasonable cause and for which the taxpayer acted in good faith. (§6664(c)(1)) The taxpayer has the burden of proving that this exception applies. (§7491(c))

Reasonable cause and good faith are determined on a case-by-case basis, taking into account all pertinent facts and circumstances. The most important factor is the extent of the taxpayer's effort to assess the proper tax liability. (Regulation §1.6664-4(b)(1)) Taxpayers can demonstrate reasonable cause and good faith if they reasonably relied on professional advice that the tax return was correct. (Regulation §1.6664-4(c)(1))

Although married persons who file a joint Federal income tax return are, as a general rule, each jointly and severally liable for the tax shown on the return and any deficiency arising from that return (§6013(d)(3)), §6015 provides for three types of relief from joint and several liability that are contained in §6015(b), §6015(c), and §6015(f).

§6015(b) provides relief for when the joint return contains an understatement of tax as a result of an incorrect revenue or expense item for one of the spouses and a number of other requirements are met. Among those requirements: that the understatement be attributable to an erroneous item of the nonrequesting spouse (§6015(b)(1)(B)); that the requesting spouse did not know, or have reason to know, of the understatement (§6015(b)(1)(C)); and that it be inequitable to hold the spouse requesting relief liable for the deficiency attributable to the understatement. (§6015(b)(1)(D))

§6015(c) affords relief from joint and several liability for a spouse who is divorced from the spouse with whom he or she filed the joint return. The requesting spouse is liable only for the portion of the liability proven to be properly allocable to him or her. (§6015(c)(1) and §6015(c)(2)) However, relief is not available with respect to a portion of a deficiency where IRS proves that the requesting spouse had actual knowledge of the item giving rise to that portion of the deficiency. (§6015(c)(3)(C))

§6015(f) allows for equitable relief under procedures prescribed by IRS if: (1) taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency and (2) relief is not available to the requesting spouse under §6015(b) or §6015(c). The requesting spouse has the burden of proving that he/she is entitled to relief. (*Alt,* (2002) 119 TC 306)

IRS's guidelines for determining whether to grant §6015(f) relief are found in Revenue Procedure 2013-34, 2013-43 IRB 397. Revenue Procedure 2013-34, §4.01, provides the threshold requirements for any request for equitable relief. One such requirement, in Revenue Procedure 2013-34, §4.01(6), is that the requesting spouse did not knowingly participate in the filing of a fraudulent joint return. Revenue Procedure 2013-34, §4.02, sets forth the conditions under which IRS will make streamlined relief determinations. Revenue Procedure 2013-34, §4.03, provides a nonexclusive list of factors for consideration in determining whether relief should be granted under §6015(f) because it would be inequitable to hold a requesting spouse jointly and severally liable when the conditions of Revenue Procedure 2013-34, §4.02, are not met.

The taxpayer was Maren Conrad (Maren).

Dennis Conrad (Dennis) and Jason Mininger (Jason) were longtime friends. They both used the same tax return preparer, Mr. Gilliam. Gilliam secured large tax refunds for his clients by, each tax year, reporting losses from fictitious partnerships. The partnership with respect to Dennis was "Conrad & Associates."

Years after both Dennis and Jason began reporting losses from Gilliam's partnerships, Dennis married Maren in 2003.

Dennis died in 2005. Maren filed joint returns with Dennis for 2003-2005 which showed Conrad & Associates losses of over $200,000 per year.

For 2006, Gilliam prepared Maren's return; that return omitted any mention of Conrad & Associates.

In 2007, Maren married Jason. Their 2007 joint return showed a $250,000 Conrad & Associates loss. The joint return also claimed a deduction for a $14,103 net operating loss carryover from Maren's 2006 return. The carryover was attributable to fictitious passthrough deductions claimed on the 2006 return and on prior returns.

The 2007 joint return reported that IRS owed Maren and Jason a refund of $113,795. IRS paid them this refund through a deposit to a bank account that was in Jason's name. Shortly after the deposit of the refund into Jason's bank account, some money was transferred from his account to a bank account to which Maren had access.

In 2011, Maren and Jason divorced. Thereafter, IRS issued a notice of deficiency to Maren and Jason for the 2007 tax year. The notice determined that the $250,000 loss from Conrad & Associates was zero. It also disallowed a deduction for the net operating loss carried over from Maren's 2006 tax return and included an accuracy-related penalty.

Maren petitioned the Tax Court seeking redetermination of the deficiency and the penalty and relief from joint and several liability.

The Court sustained the full deficiency assessed by IRS.

The Court said that the deficiency was attributable to two items on Maren and Jason's joint return for the tax year 2007. First, there was the $250,000 loss passed through from the 2007 partnership return for Conrad & Associates. Second, there was the net operating loss carryover deduction which came from prior years' returns filed by Maren.

IRS contended that all of the deductions on the 2007 partnership return were fictitious. The Court said that this contention was consistent with the record. The partnership return, like the other partnership returns that Gilliam prepared for Conrad & Associates and other clients, claimed large business expense deductions. Despite the filing of all these partnership returns for Conrad & Associates, there was no evidence in the record that Conrad & Associates actually existed. There was one unsigned partnership agreement that Gilliam produced from his files, "but there [was] no indication that this [was] anything other than window dressing." There were deeds and other documents in the record, all of which showed that the owners of various properties were Dennis, Maren, Jason, and their trusts - not Conrad & Associates. And there was no evidence of any other business being conducted in Conrad & Associates' name.

Maren did not dispute IRS's contention that all of the deductions on the partnership return were fictitious. Nor did she argue that the net operating loss carryover deduction was genuine.

The Court found Maren liable for the accuracy-related penalty. It rejected her argument that the reasonable cause/good faith exception applied because she relied on Jason and Gilliam to conclude that the 2007 return was proper.

Maren had already signed three returns, for tax years 2003, 2004, and 2005, which used Gilliam's method of claiming fictitious deductions from partnership returns (returns she also signed). The Court concluded that Maren was aware of their fictitious nature by the 2008 filing date of the 2007 return. The deductions were very large. Although Maren's financial affairs were partially controlled by Dennis and then by Jason, she understood financial affairs and she showed interest in them. Maren never received real advice from Jason, who was not a tax professional anyway, or Gilliam, that the 2007 tax return was correct. She knew the return was incorrect.

The Court determined that no spousal relief, under §6015(b), §6015(c) or §6015(f), applied.

With respect to §6015(b), it found that §6015(b)(1)(B) did not apply because both erroneous items on the 2007 joint return were attributable to Maren: (1) Jason had nothing to do with the net operating loss carryover, which was the carryover of an amount reported on Maren's 2006 return, and (2) Maren knew the deductions claimed on the 2007 partnership return (which were reflected in the loss reported on the 2007 joint return) were fictitious. It found that §6015(b)(1)(C) did not apply because, as noted above, Maren actually knew that the deductions claimed on the 2007 joint return were fictitious. It found a number of reasons that §6015(b)(1)(D) did not apply, including that Maren knew from experience that the returns prepared by Gilliam reported fictitious business-expense deductions and that she benefited from the understatement. The fact that Maren stated that the $113,795 refund resulting from the understated return was deposited into Jason's bank account did not mean that Jason exclusively benefited from the understatement. Bank records showed that shortly after the deposit of the refund into Jason's bank account, some money was transferred from his account to a bank account to which Maren had access.

The Court found numerous reasons that §6015(c) did not apply, including that, as noted above, Maren must have known that the partnership returns prepared by Gilliam were fictitious.

As to §6015(f), the Court concluded that Maren did not meet Revenue Procedure 2013-34, §4.01(6), again because she knew the 2007 partnership return was fraudulent. Furthermore, Maren would not be entitled to relief under Revenue Procedure 2013-34, §4.03, because the same factors that the Court discussed in the context of §6015(b) relief are also the equitable factors considered in Revenue Procedure 2013-34, §4.03.

Crawford, et al, v. Department of the Treasury, et al, (CA 6 08/18/2017) 119 AFTR 2d ¶ 2017-5161.

The Court of Appeals for the Sixth Circuit, affirming a district court opinion, has dismissed for lack of standing a suit brought by Senator Rand Paul (R-KY) and several individual plaintiffs challenging several aspects of the Foreign Account Tax Compliance Act (FATCA) and also challenging the Foreign Bank Account Report (FBAR) requirements. The court cited several different grounds for its decision with respect to the numerous provisions challenged by the plaintiffs. For example, it found that Senator Paul's alleged harm because he was denied the right to vote on rules that were created by the Executive branch was an insufficient injury for purposes of establishing standing.

The Hiring Incentives to Restore Employment Act of 2010 (P.L. 111-147) added Chapter 4 (§1471 through §1474, FATCA) to the Code. Chapter 4 generally requires withholding agents to withhold a 30% tax on certain payments to a foreign financial institution (FFI), unless it has entered into an FFI agreement with the U.S. to, among other things, report certain information with respect to U.S. accounts. Withholding can also apply to FFI account holders who refuse to identify themselves as U.S. taxpayers. The FATCA rules are essentially a mechanism to enforce reporting requirements. Chapter 4 also imposes withholding, documentation, and reporting requirements on withholding agents, with respect to certain payments made to certain non-financial foreign entities.

In cases in which foreign law would prevent an FFI from complying with the terms of an FFI agreement, IRS has collaborated with other governments to develop two alternative model intergovernmental agreements (IGAs) that facilitate FATCA implementation. The main distinction between the two is that under Model 1 IGAs, foreign governments agree to collect their FFIs' U.S. account information and send it to IRS, whereas under Model 2 IGAs, foreign governments agree to modify their laws to the extent necessary to enable their FFIs to report their U.S. account information directly to IRS.

Also enacted as part of FATCA were the "asset value reporting" rules of §6038D, under which individuals holding more than $50,000 of aggregate value in "specified foreign financial assets" must file a report with their annual tax returns that includes, for each asset, the "maximum value of the asset" during the tax year. (§6038D(c)(4))

The Bank Secrecy Act (BSA) gives the Treasury Department authority to collect information from U.S. persons who have financial interests in or signature authority over financial accounts maintained with financial institutions located outside of the U.S. A provision of the BSA requires that a Form 114, Report of Foreign Bank and Financial Accounts (FBAR) be filed with the Financial Crimes Enforcement Network (FinCEN, a bureau of the Treasury Department) if the aggregate maximum values of the foreign financial accounts exceed $10,000 at any time during the calendar year. Enforcement authority regarding the FBAR has been delegated to IRS, which can impose penalties for noncompliance. Penalties for willful failures to file an FBAR can be as high as $100,000 or 50% of the value of the unreported account.

The first question in every case brought in federal court is whether the court has jurisdiction, which includes the issue of standing. To obtain standing, a plaintiff must show that it suffered an injury that is fairly traceable to the defendant's conduct and capable of being redressed by favorable decision from the court.

Standing contains three elements: (1) plaintiffs must have suffered an injury in fact-an invasion of a legally protected interest which is (a) concrete and particularized, and (b) actual or imminent, not conjectural or hypothetical; (2) there must be a causal connection between the injury and the conduct complained of-i.e., the injury has to be fairly traceable to the challenged action of the defendant; and (3) it must be likely, as opposed to merely speculative, that the injury will be redressed by a favorable decision. (*Lujan v. Defs. of Wildlife,* (Sup Ct 1992) 504 U.S. 555)

The plaintiffs in this case include Senator Paul, U.S. citizens who live in foreign countries, dual citizens of the U.S. and another country, and former U.S. citizens. The plaintiffs generally challenged the validity of FATCA's reporting and withholding requirements and the penalty for willfully failing to file an FBAR, and specifically challenged the validity of several countries' IGAs with the U.S. as exceeding the proper scope of the Executive Branch's power. They further asserted, among other things, that they faced difficulties in establishing foreign accounts or were forced to divide assets as a result of FATCA, and that various elements of the overall reporting regime were unconstitutional.

In 2015, an Ohio district court denied the plaintiffs' motion for a preliminary injunction that would prevent the defendants (i.e., the Treasury Department, IRS, and FinCEN) from enforcing FATCA, IGAs negotiated by the Treasury Department, and the FBAR regime. (*Crawford, et al, v. U.S. Dept. of Treasury, et al,* (DC OH 2015) 116 AFTR 2d 2015-6288)

In 2016, that same district court granted the defendants' motion to dismiss the case, finding that all of the plaintiffs lacked standing to bring it. (*Crawford, et al, v. Dept. of the Treasury, et al,* (DC OH 2016) 117 AFTR 2d 2016-1400)

For example, Senator Paul argued that he had standing based on his institutional duty to advise and consent under the Constitution-i.e. that the IGAs exceeded the scope of the Executive Branch's power and should have been submitted for Senate approval. The court, however, rejected this argument, which it said amounted to an attempt to base standing on a loss of political power, stating that "[a] legislator does not hold any legally protected interest in proper application of the law that is distinct from the interest held by every member of the public." Senator Paul also failed to establish any injury.

The Sixth Circuit has now affirmed the 2016 district court decision, again finding that none of the plaintiffs had standing with respect to any of their claims. The following were among the Court's findings:

a. With respect to the IGAs, any incursion upon Senator Paul's political power is not a concrete injury like the loss of a private right, and any diminution in the Senate's lawmaking power is not particularized but is rather a generalized grievance. The Court said that Senator Paul did not plead that his vote on its own would have been sufficient to forestall the IGAs. Rather, Senator Paul has a remedy in the legislature, which is to seek repeal or amendment of FATCA itself, under the aegis of which Treasury is executing the IGAs.

b. With respect to the FBARs, the Court, citing the Supreme Court in *Susan B. Anthony List v. Driehaus,* (2014) 134 S Ct 2334), said that, in a pre-enforcement challenge to a federal statute, a plaintiff satisfies the injury requirement of standing by alleging "an intention to engage in a course of conduct arguably affected with a constitutional interest, but proscribed by a statute, and [that] there exists a credible threat of prosecution thereunder."

The Court here said that, although most of the plaintiffs in this case alleged foreign account balances over $10,000 so as to be subject to the FBAR requirement, no plaintiffs alleged both an intent to violate the FBAR requirement and a credible threat of the imposition of a failure-to-file penalty, as Driehaus would require in order for there to be standing to bring a pre-enforcement challenge to the FBAR penalty.

c. With respect to the FATCA individual-reporting requirements, no plaintiff had standing because no plaintiff alleged either an actual injury that was fairly traceable to FATCA or an imminent threat of prosecution from noncompliance with FATCA.

First, no plaintiff alleged any actual enforcement of FATCA such as a demand for compliance with the individual-reporting requirement or the imposition of a penalty for noncompliance.

Second, no plaintiff could satisfy the Driehaus test for standing to bring a pre-enforcement challenge to FATCA because no plaintiff claimed to hold enough foreign assets to be subject to the individual-reporting requirement, and, as a result, no plaintiff could claim that there was a "credible threat" of either prosecution for failing to comply with FATCA. All but two of the plaintiffs either failed to state the value of their foreign assets altogether or alleged only that they had foreign accounts with an aggregate value "greater than $10,000"-but FATCA's individual-reporting requirement applies only to individuals with at least $50,000 worth of assets held in foreign accounts, with significantly higher thresholds in some cases.

Crummey v. Commissioner, (CA 5 4/4/2017) 119 AFTR 2d ¶ 2017-624.

The Court of Appeals for the Fifth Circuit, affirming the Tax Court, has concluded that the penalty under §6651(a)(1) for failure to file a valid return, as increased under §6651(f) for filing a fraudulent return, and the penalty under §6651(a)(2) for failure to pay the tax shown on the return, were correctly imposed on a taxpayer improperly filing as a trust rather than an individual.

§6651(a)(1) provides for a penalty in the event a taxpayer fails to file a timely return unless the taxpayer can show that the failure is due to reasonable cause and not due to willful neglect. The penalty is a percentage of the amount required to be shown as tax on the delinquent return for each month, up to five, that the return is delinquent. Normally, the penalty is 5% a month, and it cannot exceed 25% of the amount of tax required to be shown. If any failure to file any return is fraudulent, however, §6651(f) increases the monthly penalty to 15%, and increases the maximum penalty to 75% of the amount of tax required to be shown.

A finding of fraud requires that IRS prove affirmatively by clear and convincing evidence actual and intentional wrongdoing on the part of the taxpayer, with a specific intent to evade the tax. (*Webb v. Commissioner,* (CA 5 1968) 21 AFTR 2d 1150) In determining whether a taxpayer's failure to file a legitimate tax return was fraudulent, the courts consider the following nonexhaustive list of elements: (1) understating income; (2) maintaining inadequate records; (3) failing to file tax returns; (4) giving implausible or inconsistent explanations of behavior; (5) concealing assets; (6) failing to cooperate with tax authorities; (7) engaging in illegal activities; (8) attempting to conceal illegal activities; (9) dealing in cash; and (10) failing to make estimated tax payments. (*Bradford v. Commissioner,* (CA 9 1986) 58 AFTR 2d 86-5532)

For a filing to qualify as a tax return, the document must: (a) purport to be a return; (b) be executed under penalty of perjury; (c) contain sufficient data to allow calculation of tax; and (d) represent an honest and reasonable attempt to satisfy the requirements of law. (*U.S. v. Davis,* (CA 5 2010) 105 AFTR 2d 2010-1854)

Except where the taxpayer shows that the failure is due to reasonable cause and not to willful neglect, §6651(a)(2) provides a penalty for the failure "to pay the amount shown as tax on any return...on or before the date prescribed for payment." The penalty is ½% of the tax shown for each month (or fraction of a month) that it is not paid (but not more than 25%). Any amount paid on or before the operative dates reduces the penalty subsequently assessed to a taxpayer. (§6651(b)(1), §6651(b)(2))

Before 2005, Brent Crummey filed his taxes using Form 1040 (U.S. Individual Income Tax Return). However, in 2005 and 2006, he used Form 1041 (U.S. Tax Return for Estates and Trusts) in the name of the "Brent E. Crummey Trust," a fictitious trust created by Crummey in accordance with his belief that the Social Security Administration had created a trust in his name when it assigned him a Social Security Number. Crummey's Form 1041s claimed his personal income as "other income." His Form 1041s also claimed that despite his income, he owed nothing in taxes.

In 2008, after an interview in which IRS agents explained that Form 1041 was not appropriate, Crummey filed a homemade return for the Brent E. Crummey Trust. In each of these returns, he reported his wages as trust income, but claimed "fiduciary fees" and "income distributions" that left the trust with a tax liability of zero. He never claimed any personal income relating to these fiduciary fees or income distributions, and again asserted that he owed no taxes.

In each of the years in dispute, Crummey requested a tax refund for the total amounts withheld by his employer. He received a refund for the full amount withheld in 2005 on May 30, 2006, and for the full amount withheld from 2006 on March 13, 2007. IRS did not provide Crummey with the refund that he requested for 2008.

In 2010, Crummey was indicted for and convicted of making false claims on tax refunds under 18 U.S.C. §287. Following his conviction, he submitted "amended" tax returns for the years of 2005, 2006, and 2008 in December of 2012. He also submitted a letter reiterating his unorthodox beliefs and stating that the returns were submitted "[o]ut of fear of continued prosecution... by IRS using false evidence."

Based on these returns, IRS determined that Crummey was liable for penalties under §6651(a)(1), §6651(f) and §6651(a)(2). Crummey sought relief in the Tax Court.

Crummeys contended that his 2005, 2006, and 2008 filings qualified as returns because they contained adequate data, purported to be returns, were signed under the penalty of law, and were filed in reliance on Tax Court and Supreme Court decisions that he believed showed his filings were valid. In addition, Crummey argued that these facts did not support a finding of fraud. He suggested that his returns did not conceal income or assets, or otherwise demonstrate any illegal activities on his part. He also asserted that he cooperated with tax authorities.

The Tax Court held for IRS, upholding the imposition of the penalties on Crummey for failure to timely file, fraudulent failure to file, and failure to pay tax. (*Brent Crummey,* TC Memo 2016-9)

Because the documents that Crummey originally filed were based on a fictitious trust, the Court found that they were not an honest and reasonable attempt to satisfy the requirements of the tax law. Thus, they did not qualify as valid returns for purposes of the §6651 penalty.

The Court determined that fraud was shown by the taxpayer's affirmative acts of filing false documents to claim and receive refunds of the tax withheld from his wages during 2005 and 2006: the Forms 1041 were deliberately deceiving and not honest and reasonable attempt to comply with tax law. And, he submitted similar documents even after IRS agents advised him against doing so. The Court reasoned that Crummey was not a fiduciary and did not reasonably believe that the Forms 1041 were appropriate to report his wages. The only status that those Forms 1041 had were as proof of false claims for refund; they supported his criminal conviction and the Tax Court's conclusions as to civil fraud.

The Court concluded that while Crummey filed his taxes with the usual form one uses for personal income tax (Form 1040) before 2005, he filed Form 1041 trust tax returns in 2005 and 2006 in order to have zero tax liability.

The Tax Court also found that IRS properly imposed the penalty under §6651(a)(2) for a failure to pay the amount shown on a return. IRS satisfied its burden of production, which included showing that a return was filed for each year in issue (i.e., the "amended" return filed in 2012). And, Crummey failed to show any reasonable cause that would avoid the additions to tax.

The Fifth Circuit found that the taxpayer failed to file valid returns, justifying a penalty under §6651(a)(1). The Fifth Circuit reasoned that Crummey's filings were made on the incorrect forms, and more importantly, he relied on claimed deductions for managing his "trusts" that allowed him to pay no taxes on his income. His incorrect filings and his stated reasons for making them, along with his decision not to pay taxes as a trust or an individual, echoed other tax-protestor arguments that have been found to insufficiently demonstrate an honest and reasonable attempt to satisfy the tax law.

The Court rejected the taxpayer's contention that there was not sufficient evidence to demonstrate that Crummey fraudulently filed those returns, which justified an increased penalty under §6651(f). Looking to the Bradford factors, the Court found that Crummey had understated his income, claimed to have a personal income of zero, and had participated in illegal acts, as evidenced by his conviction for tax fraud. The Court also found that Crummey's previous use of the Form 1040, along with prior IRS requests to use the correct form, showed that he was not ignorant of what the law required. The Tax Court did not err in concluding from these facts and his failure to pay any taxes at all on three years' worth of income indicated that Crummey used his "trust" scheme as a vehicle to avoid doing paying taxes; the Tax Court's conclusion was supported by the fact that Crummey did not file personal income taxes claiming the distributions he received from the "trust" as income-such distributions would have been taxable even if the "trust" was legitimate.

While agreeing that the §6651(a)(2) failure to pay penalty is imposed on the "net amount due," the Fifth Circuit rejected Crummey's contention that the Tax Court failed to consider 2006 tax withholdings in calculating the net amount due. The Court found that his argument misses a key point in the timeline concerning the 2006 withholding. Crummey applied for a refund of his 2006 withholding and received that refund on March 13, 2007. Accordingly, he was not entitled to a credit because IRS was no longer in possession of his withholding "on or before the date prescribed for payment," which was April 16, 2007.

Crummey's 2006 withholding stands in contrast to his 2005 withholding, which IRS still possessed on April 15, 2006, and for which IRS gave him credit, despite the fact that his later receipt of a refund was based on a fraudulent filing. Having received his 2006 refund prior to the date prescribed for payment, the "net amount" owed by Crummey was the equivalent of the entire amount of taxes due to IRS. The Court concluded that Crummey could not use the fraudulent refund as a shield to protect him from the penalties owed on the unpaid amounts. While Crummey received a windfall by receiving credit for his 2005 withholding because the plain language of the statute dictated such a result, the timing of his 2006 tax refund demanded a different outcome.

The Court also dismissed Crummey's argument that IRS did not take various payments made, beginning in 2013, into account when determining the penalties. These payments came too late to affect any penalty owed because they did not come "on or before" April 16, 2007, "the date prescribed for payment" for his 2006 tax return. Further, the payments came years after the maximum penalty had already accrued.

Curtis Investment Company, LLC, TC Memo 2017-150.

Custom Adjustable Rate Debt Structure (CARDS) transaction entered into by an LLC and two individuals associated with the LLC lacked economic substance and that losses stemming from the transaction were not deductible. The Court found that the transaction-which was designed and entered into for the purpose of generating a tax loss-presented no real opportunity for profit and that the taxpayers had no valid non-tax reasons for participating in it. And, the Court upheld IRS's imposition of 40% gross valuation misstatement penalties, rejecting the taxpayers' claim that they acted reasonably and in good faith.

To determine whether a transaction has economic substance, courts usually make a two-pronged factual inquiry:

1. Was the taxpayer motivated by no business purpose (other than getting tax benefits) in entering into the transaction? (subjective test)

2. Did the transaction have objective economic substance, i.e., was there a reasonable possibility of a profit? (objective test) (*Frank Lyon Co v. U.S.,* (S Ct 1978) 41 AFTR 2d 78-1142)

The economic substance doctrine allows the government to look beyond technical compliance with the Code to ascertain the real nature of the transaction at issue.

The Circuits have differed in their application of the two-prong test. A number of Circuits, including the Eleventh Circuit (*United Parcel Service of America Inc.,* (CA 11 2001) 87 AFTR 2d 2001-2565), require that a transaction have both a subjective business purpose and objective economic substance in order to be respected (the conjunctive test). On the other hand, the Fourth Circuit requires only that a transaction have either a subjective business purpose or objective economic substance in order to be respected (the disjunctive test). (*Rice's Toyota World Inc. v. Commissioner,* (CA 4 1985) 55 AFTR 2d 85-580)

Observation: For transactions entered into after March 30, 2010-i.e., after the time period involved in this case-the Health Care and Education Reconciliation Act (P.L. 111-152, 3/30/2010) added §7701(o). Under a conjunctive two-prong test, it provides that a transaction is treated as having economic substance only if, apart from Federal income tax effects, both: (1) the transaction changes the taxpayer's economic position in a meaningful way; and (2) the taxpayer has a substantial purpose for entering into the transaction. That is, the taxpayer's non-Federal-income-tax purpose for entering into a transaction must be "substantial."

A CARDS transaction is, in effect, a complex transaction designed to create an artificial capital loss to offset an unrelated capital gain. As previously described by the Third Circuit in *Cirpin v. Commissioner,* (CA 3 2013) 111 AFTR 2d 2013-829, which involved a transaction similar to the one in this case:

A CARDS transaction is a tax-avoidance scheme that...purports to generate, through a series of pre-arranged steps, large "paper" losses deductible from ordinary income. First, a tax-indifferent party...borrows foreign currency from a foreign bank (a "CARDS Loan"). Then, a United States taxpayer purchases a small amount...of the borrowed foreign currency by assuming liability for an equal amount of the CARDS Loan. The taxpayer also agrees to be jointly liable with the foreign borrower for the remainder of the CARDS Loan and so the taxpayer purports to establish a basis equal to the entire borrowed amount. Finally, the taxpayer exchanges the foreign currency he purchased for United States dollars. That exchange is a taxable event, and the taxpayer claims a loss equal to the full amount of his supposed basis in the CARDS Loan, less the proceeds of the relatively small amount of currency actually exchanged. The taxpayer uses that loss to shelter unrelated income.

The CARDS strategy was targeted by IRS in August of 2000 in Notice 2000-44, 2000-2 CB 255. That Notice warned taxpayers that noneconomic losses produced by certain basis-inflating transactions are not allowable as tax deductions.

Taxpayers are subject to a 20% accuracy-related penalty for an underpayment of tax required to be shown on a return that is attributable to a substantial valuation misstatement. (§6662(a), §6662(b)(3)) The penalty is 40% of the portion of an underpayment of tax attributable to one or more substantial valuation misstatements that meet the requirements for a "gross valuation misstatement"-i.e., one where the value or adjusted basis of any property claimed on a tax return is 200% or more of the amount determined to be the correct amount of such value or adjusted basis. (§6662(h)) The accuracy-related penalty does not apply, however, with respect to any portion of the underpayment for which the taxpayer shows that there was reasonable cause and that he or she acted in good faith. (§6664(c))

The Supreme Court in *U.S. v. Woods,* (S Ct 2013) 112 AFTR 2d 2013-6974, resolving a split in the circuits, held that the valuation misstatement penalty could be imposed where the underlying transaction lacked economic substance.

Curtis Investment Company LLC (Curtis Investment), a holding company formed by the Curtis family, owned approximately 30% of the stock of American Business Products, Inc. (ABP), as well as other assets. Mrs. Baxter, a member of the Curtis family, became managing member of Curtis Investment in 1986, and her son, Mr. Bird, assumed that role in 1998. In late 1999 or early 2000, ABP received a tender offer for the purchase of the company, which its board accepted. In February 2000, Curtis Investment sold ABP stock, generating approximately $28.6 million in long-term capital gain. Mrs. Baxter also sold ABP stock generating approximately $2.4 million in long-term capital gain and $19,000 in short-term capital gain.

In the fall of 2000, knowing that the sales of ABP stock would generate substantial tax liabilities, an accountant recommended a CARDS transaction to Curtis Investment and Mrs. Baxter. Mr. Bird had various legal and financial advisors, some of whom were also promoters of the transaction, review the transaction. He received a model opinion letter drafted by a law firm concluding that the transaction would "more likely than not" have economic substance. While none of the advisers actually provided their own opinion letters, they generally concurred with the model opinion letter as to the tax consequences of the transaction. Mr. Bird himself also researched the investment potential of the CARDS transaction and concluded that it would be profitable. They decided to participate.

The CARDS transaction resulted in a purported $28 million loss for Curtis Investment and a $2.3 million loss for Mr. and Mrs. Baxter. Both Curtis Investment and the Baxters reported these losses, as well as the long- and short-term gains from the ABP stock sale, on their 2000 returns. IRS, however, determined that they were not entitled to a capital loss deduction as a result of the CARDS transaction because it lacked economic substance. IRS also found that they were liable for gross valuation misstatement penalties.

In this case, Curtis Investment (an LLC organized in Georgia) would appeal the Tax Court's decision to the Fourth Circuit, whereas the Baxters (residents of South Carolina) would appeal to the Eleventh Circuit. Therefore, in determining whether the transaction had economic substance, the Court had to apply the disjunctive test with respect to Curtis Investment and the conjunctive test with respect to the Baxters.

The Tax Court explained that, to satisfy the objective test, a transaction must be objectively likely to produce economic benefits other than the generation of a tax deduction. (*Glass,* (1986) 87 TC 1087) Curtis Investment and the Baxters argued that the Court should consider the profit potential from returns on investments that were purchased with proceeds of the CARDS transaction, but the Court rejected this argument, focusing instead on the transaction itself that gave rise to the tax loss. The Court then concluded that the CARDS transaction in this case, like prior ones it had considered, did not provide an objectively reasonable possibility of profit. Rather, the transaction was purposefully entered to create tax losses, and the Court found that "any testimony to the contrary is simply not credible."

The Court noted that its conclusion that the CARDS transaction failed the objective test was enough for it to conclude that, with respect to Curtis Investment, the CARDS transaction lacked economic substance. However, it continued to apply the subjective test, satisfaction of which was also required to reach a similar conclusion with respect to the Baxters. The subjective test looks to whether there was a business purpose for a transaction-or, put otherwise, whether the transaction would have occurred absent tax avoidance reasons. The Baxters claim that their business purpose was to obtain proceeds for investment, but the Court found that this claim was belied by the facts of the transaction, including the high financing costs incurred, the overall timing, and the fact that the Baxters did not explore less expensive financing arrangements or attempt to obtain any other loan or maximize the amount they could borrow.

Finally, the Tax Court upheld IRS's imposition of a 40% gross valuation misstatement penalty, citing Woods. The Court noted that the Tax Court had previously found that a taxpayer acted with reasonable cause and good faith when (a) a deficiency was the result of an issue of first impression and the taxpayer's position was reasonably debatable; or (b) a taxpayer took a position on an initial interpretation of a statute and the statutory text was unclear. However, the Court rejected the argument that the CARDS transaction presented novel issues, finding that IRS had already taken an unfavorable position with regard to CARDS transactions in Notice 2000-44 (and that this Notice was discussed in the model opinion letter concerning the transaction); and even if it had presented novel issues, the facts of the case otherwise weighed against a finding of reasonable cause and good faith. Notably, any claimed reliance on tax advisers was belied by the fact that they had an inherent conflict of interest, and the Baxters, as well as Mr. Bird, were all financially sophisticated.

Davis, (DC LA 1/5/017 119 AFTR 2d ¶ 2017-309.

Where a law firm owed back taxes, a district court has allowed IRS to foreclose its liens on and sell a property co-owned by three persons, two of which owned the law firm. The Court found that IRS met all of the standards set by the Supreme Court in Rodgers with respect to the innocent third owner's interest and that a purchase of tax sale title on the property by an unrelated party had no effect on IRS's lien.

Under §6331(a), IRS can levy on all property and rights to property of a taxpayer on which there is a federal tax lien, in order to collect delinquent taxes. As an alternative to a levy, IRS may bring a lien foreclosure suit under §7403, i.e., an action in federal district court, to reach the funds.

The Supreme Court, in *U.S. v. Rodgers,* (S Ct 1983) 52 AFTR 2d 83-5042, held that §7403 empowers a district court to enforce a tax lien by decreeing a forced sale of an entire property in which a delinquent taxpayer has an interest, even though a nondelinquent person also has an interest in the same property. The nondelinquent person is entitled to receive an appropriate portion of the sales proceeds. Under certain circumstances, the district court may use its discretion to disallow a request for the forced sale. This discretion should be exercised in the light of the following considerations:

a. The extent to which government financial interests would be prejudiced by relegating it to a forced sale of the partial interest;

b. Whether an innocent/nondelinquent third-party has a legitimate or legal expectation that his separate interest would not be subject to a forced sale by the delinquent taxpayer or his creditors;

c. The likely prejudice to the third party, both in personal dislocation costs and in practical undercompensation; and

d. The relative character and value of the nonliable and liable interests held in the property.

A nonjudicial sale will be made subject to, and without disturbing, IRS's lien, if, more than 30 days before the date of sale, a notice of lien is properly filed or if the title derived from enforcement of lien is recorded as provided by local law, and IRS is not given notice of the sale (§7425(b)). That notice must be in writing by registered or certified mail or personal service, not less than 25 days prior to the sale. (§7425(c))

A Louisiana tax title sale is the sale of properties that have delinquent taxes due and owing a political subdivision. These properties are sold to the public for the amount of delinquent taxes due, plus any accrued interest, penalties, etc. If a property is sold at tax sale, the property owner has three years to redeem the property from the purchaser. (La. R.S. 47:2243) A tax sale title confers on the tax sale purchaser, if the tax sale property is not redeemed within the redemptive period, full ownership of the tax sale property. (La. R.S. 47:2121C)

The law firm owned by S.P. Davis, Sr. (Davis) and Singleton failed to pay federal payroll taxes in the late 1990s. IRS made assessments against Davis and Singleton (Defendants), for these unpaid taxes.. In 2003, IRS filed a Notice of Federal Tax Lien in Caddo Parish, Louisiana regarding these unpaid taxes as to Davis and Singleton. IRS re-filed these liens in 2011.

On May 15, 2012, Boardwalk Investors/US Bank (Boardwalk Investors) purchased tax sale title to the property at 4050 Linwood Avenue, Shreveport, Louisiana 71108 after the property taxes were not paid. Davis, Singleton, and Andrew Davis, Jr. (Andrew) had purchased this property in 1984, with each taking an undivided one-third interest in the property. The law firm's office was on this property. Andrew was not liable for the unpaid taxes.

Though notice of the sale was provided in a local newspaper in accordance with Louisiana law, notice of the sale was not provided to IRS in the manner required by §7425(c).

IRS sought a judgment permitting foreclosure on the property and permission to sell the property as a whole, with payment of a portion of the proceeds to Andrew for his interest and repayment of the property taxes paid by Boardwalk Investors.

The court said that, as a threshold matter, Boardwalk Investors' purchase of tax sale title did not affect IRS's lien on the property. There was no indication that IRS was ever provided with the written notice required for sale of property in which IRS had an interest, in accordance with §7425(b). Such notice is required if IRS's lien is on file for more than 30 days in the real property records of Caddo Parish. As IRS filed the Notice of Federal Lien for the property in question in 2003 and renewed it in 2011, notice in accordance with §7425(b) was required.

The court, siding with IRS, approved the sale of the entire property.

Defendants, in arguing against such a sale, said that (1) the property in question would not sell for its appraisal value and would represent a tiny portion of the overall tax debt; (2) IRS could not show that it would be prejudiced if the Court decided not to allow a forced sale to proceed; (3) allowing a forced sale would be "an unjust and harsh remedy"; (4) IRS was pursuing this remedy out of a "punitive and retaliatory motive" evidenced by the fact that IRS had not pursued such remedies against Davis and Singleton's former co-owners of the law firm; (5) Davis and Singleton would be greatly prejudiced by allowing a forced sale of the property.

The court said that Defendants' arguments were mostly irrelevant under the Rodgers factors. The property's likely sale price as a portion of the total tax debt of the taxpayer is not a relevant consideration under Rodgers. IRS is not obligated to show that it will be prejudiced if the court declines to order foreclosure and sale. Allowing a foreclosure and forced sale is a harsh remedy, but it is one that is expressly allowed by §7403 to satisfy a federal tax debt. Whether the forced sale is an unjust remedy in a particular case is an equitable determination to be made under the Rodgers framework, but the Court in Rodgers expressly declined to give any weight to considerations of fairness to the delinquent taxpayer. IRS's motive in filing a foreclosure action is also not relevant under Rodgers.

And, the court said, IRS's arguments correctly applied the Rodgers factors. The important consideration under the first Rodgers factor is whether IRS would be prejudiced if it were forced to foreclose upon and sell only the portion of the property owned by the delinquent taxpayers themselves and not the portion owned by nonliable co-owners. The Court found that IRS's overall recovery would be lower if it were forced to foreclose upon only the portion of the property owned by Davis and Singleton. Partial interests in property often sell for less than an equivalent pro rata share of the whole property, and courts have recognized this fact in the context of valuing property interests for tax purposes. See, for example, *Estate of Baird,* TC Memo 2001-258 (recognizing that under Louisiana law, there are uncertainties and disabilities associated with an undivided minority interest in property that reduce the value of such an interest to less than it is pro rata value). Thus, the first Rodgers factor weighed in IRS's favor, as IRS would be prejudiced if it were only able to foreclose upon and sell Davis and Singleton's interests in the property.

As to the second factor, the court noted that Rodgers said that, under Texas law, all co-owners have the right to seek a partition by judicial sale of the property in which they own an interest. Rodgers stated that there is a much weaker argument against foreclosure and sale when the nonliable property interest is a mere fractional undivided interest in the property rather than a protected interest like a homestead interest.

Co-owners under Louisiana law, like tenants in common and joint tenants under the common law property system, have a right to demand partition in kind or by sale. Thus, Andrew owned a fractional undivided interest in the property and had little protection against a forced sale. Therefore, the second factor also weighed in favor of IRS.

As to the third factor, the property at issue was commercial property used for the operation of Davis and Singleton's law offices. Defendants made no argument that Andrew currently used any part of the property for a commercial purpose, such as the operation of a business of his own, so there was no evidence that any prejudice in the form of personal dislocation costs to him would result from foreclosure and sale. Sale of the entire property would result in a higher sale price for all involved, including Andrew; thus, he would suffer no prejudice from undercompensation. The same was true of Boardwalk Investors' tax sale title, as such title conveys no possessory rights to its owner.

As to the fourth factor, Rodgers stated that when the nonliable party "has no present possessory or fee interest in the property, there may be little reason not to allow the sale... If, on the other hand, the [nonliable] party not only has a possessory interest or fee interest, but that interest is worth 99% of the value of the property, then there might well be virtually no reason to allow the sale to proceed." Boardwalk Investors' rights in the property were limited and nonpossessory, so they were miniscule compared to the portion of the property subject to the federal tax lien. Andrew's interest was an undivided 1/3 interest in the property, which meant that it fell somewhere between the two extremes mentioned in Rodgers. The court found that this factor weighed in favor of IRS, as 2/3 of the property was subject to IRS's tax lien.

Estate of Robert Duncan, TC Memo 2016-204.

IRS's levy determinations against a taxpayer and her deceased husband's estate stemming from, among other things, their participation in a Son of BOSS tax shelter upheld. The taxpayers' claim that IRS violated a closing agreement by not requiring any payment at the time of execution, but later assessing a deficiency and penalty, was rejected. The Court also found no abuse of discretion in rejecting the taxpayers' offer to compromise over $3 million in liabilities for $40,000.

§6320(a)(1) and §6330(a)(1) require IRS to give a taxpayer written notice when a Federal tax lien is filed upon the taxpayer's property or when IRS intends to levy upon the taxpayer's property. The notices must inform the taxpayer of the right to request an administrative Collection Due Process (CDP) hearing in the Appeals Office. If such a hearing is timely requested, it is held before an impartial officer or employee of IRS, and the taxpayer may raise any relevant issue. (§6320(a)(3)(B), §6330(a)(3)(B)) However, a taxpayer is precluded from contesting the existence or amount of the underlying tax liability at such a hearing unless the taxpayer did not receive a deficiency notice or otherwise have an opportunity to dispute the liability. (§6330(c)(2)(B))

After the administrative hearing is completed, the Appeals Office issues a written notice of determination indicating whether the notice of Federal tax lien should remain in effect and/or whether the proposed levy may proceed. (§6330(c)(3), Regulation §301.6320-1(e)(3), Q&A E8, Regulation §301.6330-1(e)(3), Q&A E8) The written notice must be sent by certified or registered mail (Regulation §301.6330-1(e)(3), Q&A E8) to the taxpayer's last known address. (*Weber,* (2004) 122 TC 258)

A taxpayer may appeal the Appeals Office determination to the Tax Court within 30 days of the determination, and if an appeal is timely filed, the Court will have jurisdiction with respect to the matter. (§6330(d)(1), Regulation §301.6330-1(f)(1))

In general, an offer in compromise (OIC) is an agreement between a taxpayer and IRS that settles the taxpayer's tax liabilities for less than the full amount owed. An OIC is generally not accepted if IRS believes that the liability can be paid in full through a payment agreement or in a lump sum. IRS looks at the taxpayer's income and assets to make a determination of the taxpayer's reasonable collection potential (RCP).

IRS will consider an OIC where: (1) the taxpayer is unable to pay the tax; (2) there is doubt as to the taxpayer's liability for the tax; or (3) a compromise would promote effective tax administration because collection of the full amount of tax would cause economic hardship for the taxpayer, or compelling public policy or equity considerations provide a sufficient basis for compromising the liability. (Regulation §301.7122-1(b))

Jannette and Robert Duncan were the sole partners in a family partnership called RCD Investments, Ltd. (RCD). In 1999, the Duncans participated through RCD in a series of transactions constituting a Son of BOSS tax shelter that generated $4.9 million of fictitious short-term capital losses for 1999 that were passed through to their individual return. The Duncans claimed $1.4 million of this loss as a deduction on their 1999 return and carried forward the remaining $3.5 million to their 2000 return.

Separately, RCD claimed deductions of approximately $48 million and $49 million, for 2000 and 2001 respectively, for alleged bad debt losses. These deductions were likewise passed through to the Duncans' individual returns. As a result of these alleged losses and various loss carryforwards, the Duncans reported a substantial net operating loss (NOL) on their 2001 return. In 2002, the Duncans filed a Form 1045, Application for Tentative Refund, claiming a refund attributable to an NOL carryback of $10 million from 2001 to 1996. IRS processed this claim and in November 2002 issued them a refund of $2.8 million for 1996. Mr. Duncan passed away in 2003.

IRS selected RCD's and the Duncans' returns for examination. Ms. Duncan and Mr. Duncan's estate (taxpayers) elected to participate in a settlement initiative for taxpayers who had engaged in Son of BOSS transactions. On September 24, 2004, they signed Form 13586-A, Settlement Initiative Declaration, reporting $4.9 million of tax benefits claimed on their 1999-2000 individual returns as attributable to the Son of BOSS transactions. Then, in October 2004, taxpayers and the revenue agent separately agreed to the disallowance of the $48 million bad debt loss deduction that RCD had claimed for 2000.

In December 2004, the revenue agent sent taxpayers a Form 906, Closing Agreement on Final Determination Covering Specific Matters that memorialized the parties' settlement of the Son of BOSS transactions, as well as two Forms 4549, Income Tax Examination Changes. The Form 4549 for 2000 showed a $1.9 million deficiency attributable to disallowance of RCD's bad debt loss deduction and adjustments to NOL carryforwards and carrybacks. The Form 4549 for 1996 showed an overassessment of $2.2 million attributable largely to NOL carrybacks. Since IRS had previously issued taxpayers a refund of $2.8 million for 1996, this Form 4549 showed a balance due of $600,000. Finally, the revenue agent sent taxpayers a Form 870, Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment, reflecting the deficiency for 2000 and the balance due for 1996. On December 30, 2004, taxpayers executed and mailed the Form 906 closing agreement and the Forms 870 and 4549 waiving restrictions on assessment. Although taxpayers are generally required to pay all liabilities due upon execution of Form 906, no payment was required in this case because the revenue agent had determined that any tax liability from the settlement was absorbed by NOL carryforwards and carrybacks.

The case was then assigned to a new revenue agent, who sent taxpayers a fully executed copy of the closing agreement on January 24, 2005. However, the new revenue agent then discovered a number of errors and subsequently determined that the taxpayers were liable for an $83,000 deficiency for 1996, a $2 million deficiency for 2000 ($740,000 of which was attributable to the Son of BOSS transactions), and a $74,000 penalty for 2000 for the Son of BOSS transactions. In April 2006, taxpayers were sent updated Forms 4549 reflecting these adjustments as well as a Form 870-PT, Agreement for Partnership Items and Partnership Level Determinations as to Penalties, Additions to Tax, and Additional Amounts, reflecting the disallowance of RCD's $48 million bad debt loss deduction for 2000. Taxpayers signed the Form 4549, including the form's consent to assessment and collection, and IRS assessed the agreed liabilities in December 2006.

In March 2007, IRS sent taxpayers a levy notice for their 1996 liability. The taxpayers challenged it and submitted an OIC, which was rejected because they had agreed to the deficiency and waived restrictions on assessment. A levy notice for their 2000 liability was sent in November 2008, which the taxpayers challenged and which was sustained on similar grounds.

The taxpayers then timely petitioned for review of IRS's determinations sustaining both levies. With respect to the 1996 determination, they argued that the assessment was untimely and that the settlement officer did not verify that all applicable procedural requirements were met. For the 2000 determination, they claimed that the assessment was invalid and that the settlement officer did not adequately consider collection alternatives.

While the cases were pending, taxpayers submitted a new OIC of $60,000 to settle tax liabilities that, including interest, exceeded $3 million. The cases were remanded to IRS's Appeals Office for consideration. The taxpayers submitted a schedule of assets that showed a net worth of over $8 million as of January 2003, but subsequently submitted a statement showing net assets and expected future income of $546,000 as of 2014. The taxpayers then submitted a new OIC for $40,000, based on "special circumstances." The settlement officer, while unable to compute the exact RCP, found that the taxpayers had dissipated at least $3.4 million of assets and that their remaining assets exceeded

$7.6 million. He also found that their special circumstances did not justify accepting the OIC. Accordingly, he rejected their $40,000 OIC and sustained the levies.

The Tax Court agreed that the taxpayers could not challenge the validity of their underlying liabilities because they had signed Forms 4549, waiving their right to do so. It then considered whether the settlement officer abused his discretion in rejecting the OIC and sustaining the levies and found that he did not.

The Court first rejected the taxpayers' claim that the settlement officers failed to verify during the initial CDP hearings that the tax liabilities in question had been properly assessed. The Court found that IRS was not required to mail a deficiency notice before assessing the liability in this case because taxpayers had waived restrictions on assessment. (§6213(d)) In addition, the Court rejected the taxpayers' argument that the fact that the settlement officer did not require payment at the time the settlement closing agreement was executed meant that no tax or penalty would be due. At the time of execution, IRS believed that the disallowance of the Son of BOSS tax benefits would operate merely to reduce carryforwards and carrybacks, and only later discovered errors and omissions that required recalculation of the taxpayers' tax liabilities for 1996 and 2000. Contrary to the taxpayers' argument, nothing in the closing agreement prevented IRS from determining the liabilities at issue-and the claim that such was implied was contrary to §7121(b), under which a closing agreement binds parties only to the matters expressly agreed upon.

Turning to the taxpayers' OIC, the Court found that the settlement officer's determination that their RCP exceeded their $40,000 offer was not arbitrary or capricious. The settlement officer reasonably concluded that the value of dissipated assets should be included in their RCP-and, even accepting the taxpayers' representation of their RCP as $546,000, the over-$500,000 difference would similarly justify rejection. The Court also found no abuse of discretion in the settlement officer's conclusion that no special circumstances were shown that would warrant compromise.

Fagan, TC Summary Opinion 2017-61.

In a Summary Opinion, IRS's authority to apply overpayments against any of the taxpayer's other tax liabilities did not apply because there was not actually any overpayment.

IRS has the authority to credit any overpayment against any liability and refund the remainder, if any. (§6402(a))

The taxpayer, Mr. Fagan, had various unpaid tax liabilities, including unpaid withholding tax for the fourth quarter of 2007. IRS and Fagan reached a settlement with respect to Fagan's unpaid liabilities, in which Fagan was to pay off an agreed-upon sum via 12 monthly payments. After the settlement was reached and was the basis for a decision entered by the Tax Court, Fagan realized that he had already paid off the withholding tax for the fourth quarter of 2007. At that point, he contacted IRS who told him that the payments that he made for that quarter would be available to him after the final payment on the installment agreement.

Fagan complied with the installment agreement, making all agreed-upon payments.

Thereafter, Fagan discovered, when he made a payment with respect to a 2011 income tax liability, that the payment was applied, in part, against his 2007 fourth quarter withholding taxes.

Fagan then brought this case to have that payment applied fully to his 2011 tax liability.

The Court rejected IRS's argument that §6402 's authority to apply overpayments to any outstanding tax liability authorized its actions here.

The Court said that Fagan was not claiming an overpayment or credit. He had shown that his payments, both under the installment agreement and otherwise, satisfied all outstanding liabilities against him, including the 2011 income tax.

IRS's position that this case involved an overpayment was incorrect. There were payments that were made in satisfaction of a series of outstanding tax liabilities. There were misapplications of payments that Fagan and IRS had agreed were to be applied against specific liabilities. Such payments were not "overpayments" which are covered by §6402 as they were payments that IRS agreed to apply against specific tax liabilities. IRS applied one of Fagan's refunds to accounts that had previously been satisfied.

The Court ruled that the payment in question should be applied against the 2011 income tax.

Fitzpatrick, TC Memo 2017-88.

The rule which allows courts to award taxpayers legal fees at a rate higher than the statutory rate, based on the difficulty of the issues, did not apply to the taxpayer's trust fund recovery penalty (TFRP) case because the law in that area is well established. The Court also ruled on whether other factors justified an above-statutory-rate award and on whether IRS's position was substantially justified.

Under §6672(a), if an employer fails to properly pay over its payroll taxes, IRS can seek to collect a TFRP in an amount equal to 100% of the unpaid taxes from a person who: (1) is a "responsible person"-i.e., one who is responsible for collecting, accounting for, and paying over payroll taxes; and (2) willfully fails to perform this responsibility.

§7430(a) permits the award of reasonable administrative and litigation costs to a taxpayer in an administrative or court proceeding brought against IRS in connection with the determination of any tax, interest, or penalty. One requirement that a taxpayer must meet in order to receive an award is that he or she is the prevailing party. (§7430(b)(1))

Generally, a taxpayer will not be treated as a prevailing party if IRS establishes that its position in the proceeding was "substantially justified." (§7430(c)(4)(B)(i)) However, where IRS establishes that its position was substantially justified, a taxpayer can still be considered a prevailing party if the taxpayer's liability under the judgment in the proceeding is equal to or less than the liability of the taxpayer which would have been so determined had IRS accepted a "qualified offer" made by the taxpayer. (§7430(c)(4)(E)(i)) Costs recoverable under the qualified offer rule only include those costs incurred on or after the date of the last qualified offer. (Regulation §301.7430-7(a)) For all other claimed costs, IRS may assert its substantial justification defense pursuant to the general prevailing party rule of §7430(c)(4).

IRS's position in an administrative proceeding is determined on the earlier of: (1) the date of receipt by the taxpayer of the decision of IRS's Appeals Division or (2) the date of the notice of deficiency. (§7430(c)(7)(B))

An award of attorney's fees under §7430 is generally limited to a statutory rate "unless the court determines that...a special factor, such as the limited availability of qualified attorneys for such proceeding, the difficulty of the issues presented in the case, or the local availability of tax expertise justifies a higher rate." (§7430(c)(1)(B)(iii))

The taxpayer, Ms. Fitzpatrick, was the subject of a TFRP investigation arising from unpaid employment taxes. Fitzpatrick requested a collection due process (CDP) hearing where she was allowed to challenge her underlying liability.

During the CDP hearing on November 7, 2012, Fitzpatrick submitted a §7430 qualified offer. The settlement officer neither accepted nor rejected the qualified offer, and he instead allowed it to lapse. The settlement officer issued a notice of determination stating that Fitzpatrick was liable for the TFRPs.

Fitzpatrick filed a petition with the Tax Court seeking review of the determination; the Court held that Fitzpatrick was not liable for the TFRPs. (*Fitzpatrick,* TC Memo 2016-199; Fitzpatrick I) Fitzpatrick subsequently moved for an award of administrative and litigation costs.

The Court held that IRS's position was substantially justified and thus Fitzpatrick could not recover administrative costs incurred before November 7, 2012.

IRS agreed that Fitzpatrick submitted a qualified offer on November 7, 2012, and that her liability pursuant to the Fitzpatrick I opinion was less than the amount of the qualified offer. Consequently, IRS conceded that Fitzpatrick was a prevailing party pursuant to §7430(c)(4)(E)(i) for costs incurred on and after November 7, 2012. IRS maintained, however, that its position was substantially justified and that Fitzpatrick should therefore not recover administrative costs incurred before November 7, 2012.

The Court said that, in general, IRS's position is substantially justified if, on the basis of all of the facts and circumstances and the legal precedents relating to the case, IRS acted reasonably. IRS's position may be substantially justified even if incorrect, if a reasonable person could think it correct. IRS's eventually conceding or losing a case does not establish that its position was not reasonable.

The Court said that, in evaluating IRS's justification, it had to first identify when IRS took a position and then decide whether the position taken from that point was substantially justified. Based on the rule of §7430(c)(7)(B), it concluded that IRS's position was established when the settlement officer issued the notice of determination determining that Fitzpatrick was a responsible person who willfully failed to pay over taxes.

IRS argued that the settlement officer's determination was substantially justified because the administrative record showed that Fitzpatrick: (1) invested money in the business, (2) opened the business's bank account as secretary for the corporation, (3) maintained signatory authority over the bank account, (4) signed checks for the corporation, (5) monitored the corporation's bank account, (6) contracted with Paychex to provide payroll services, and (7) directed and/or authorized spending by the general manager.

The Court reviewed the administrative record and agreed with IRS that a reasonable person could conclude that many of the above items were true. It also agreed that under those circumstances a reasonable person could conclude that Fitzpatrick was liable for the TFRPs. Accordingly, it held IRS's position was substantially justified for the period up until the qualified offer was made.

The Court noted that, in Fitzpatrick I, the Tax Court had determined that the administrative record was flawed due to misinformation placed into that record by executives of Fitzpatrick's employer. And it said that its ruling on substantial justification was based only on the information in the administrative record-i.e., the information available to the settlement officer when he made his determination.

The Court then determined that, with respect to the costs that Fitzpatrick incurred from the date the qualified offer was submitted, she was only entitled to the statutory rate for attorney fees.

Fitzpatrick argued that she should be entitled to recover costs in excess of the statutory cap because of various special factors, including the difficulty of the case, the tax controversy expertise of her attorney, Mr. Johnson, the limited number of tax controversy attorneys in her local area, undesirability of the case, and IRS's "unusually litigious position." The Court rejected all of Fitzpatrick's arguments.

Fitzpatrick argued that this was "not a simple case to try." The Court disagreed, stating that the law in the TFRP area is well established, and, as a result, this factor did not support a departure from the statutory rate.

Fitzpatrick next argued that Mr. Johnson was exceptionally qualified to prosecute this case. The Court said that Mr. Johnson was certainly a qualified attorney. He was board certified in taxation and had practiced in the area of tax controversy for over 30 years (including four years with the Office of Chief Counsel). However, the Court said, courts generally do not recognize knowledge in tax as a factor leading to enhanced recovery. Rather, a "special factor" in this context means a nonlegal or technical ability possessed by the attorney. Because Fitzpatrick failed to establish that Mr. Johnson possessed nonlegal or technical abilities apart from his expertise in tax law, this factor did not support a departure from the statutory rate

As to the limited-number-of-attorneys argument, the Court took judicial notice of the fact that numerous other attorneys were listed as counsel to various taxpayers at the same December 2015 trial session where Fitzpatrick I was first tried.

Fitzpatrick's next argument was that she could not afford to litigate this case and that few law firms "would have made similar arrangements to continue to absorb significant attorney's fees and costs with only limited money coming in." Fitzpatrick cited no authority that this is a factor courts have generally considered. And, the Supreme Court has held that the "undesirability of the case" is not a special factor warranting a departure from the statutory cap. (*Pierce v. Underwood*, (S Ct 1988) 487 U.S. 552)

Finally, Fitzpatrick argued that she was entitled to an enhanced recovery because IRS took an "unusually litigious" position in prosecuting this case. She cited *Jean v. Nelson,* (CA 11 1988) 863 F.2d 759, which used that language when it remanded the issue to a district court.

But, the Court here said that other courts have looked at this issue, and most of those courts have concluded that an unusually litigious position cannot be considered a special factor because it would amount to "an impermissible award of punitive damages, contrary to the statute and to principles of sovereign immunity." And, the Court said, an argument that IRS was unusually litigious does not explain why a departure from the statutory rate is appropriate; it merely explains why there may be an increase in the number of hours required to litigate the case.

Fitzpatrick, TC Memo 2016-199.

Spouse of one of a business's owners who had signatory authority over the company's checking account was not a "responsible person" for purposes of the §6672 trust fund recovery penalty. Her position in the company was largely ministerial and she lacked the authority to control the financial affairs of the business or exercise any significant authority over the disbursement of the company's funds.

§6672 imposes a responsible person penalty on any person who: (1) is responsible for collecting, accounting for, and paying over payroll taxes; and (2) willfully fails to perform this responsibility. The amount of the penalty is equal to the amount of the tax that was not collected and paid.

In determining whether an individual is a responsible person, courts consider factors including whether the taxpayer served as an officer of the corporation or a member of its board of directors, owned a substantial amount of stock in the company, participated in day-to-day management of the company, determined which creditors to pay and when to pay them, had the ability to hire and fire employees, or possessed check writing authority. Not every factor must be present; instead, a court must consider the totality of the circumstances to determine whether the individual in question had the effective power to pay the taxes owed. There can be more than one responsible person in a business.

Willfulness for purposes of §6672 includes a voluntary, conscious and intentional act to prefer other creditors over the U.S. Thus, if a responsible person knows that withholding taxes are delinquent, and uses corporate funds to pay other expenses, such failure to pay withholding taxes is deemed "willful." (*Mazo v. U.S.,* (CA 5 1979) 43 AFTR 2d 79-853, *Thibodeau v. U.S.,* (CA 11 1987) 60 AFTR 2d 87-5763)

James Stamps and Edward Fitzpatrick jointly purchased the franchise rights and opened a restaurant and wine bar (the Grape) in Florida. Mr. Stamps served as president and managing partner overseeing the business operations while Mr. Fitzpatrick, who already had a busy full time job, was a "silent partner" and passive investor with some executive authority but no day-to-day duties. The Dey Corp was incorporated, with Mr. Stamps listed as an officer and director, to buy the Grape franchise. Mrs. Fitzpatrick, Edward's wife, had no ownership interest in the business.

Mrs. Fitzpatrick's primary responsibility during the periods at issue was to serve as caregiver to her disabled son, who had severe autism, cerebral palsy, and limited mobility. Her son, who was also speech impaired and needed help to perform many basic functions, required constant adult supervision. However, when Mr. Stamps was unexpectedly unavailable, she was directed by her husband to carry out some of the preliminary preopening responsibilities for the restaurant, including checking the site premises during construction and resolving permitting issues.

When Mr. Fitzpatrick and Mr. Stamps were out of state at training by the franchisor, Mrs. Fitzpatrick was asked to retain a payroll company. She engaged Paychex to prepare employee paychecks, determine payroll tax liability, debit the business's bank account, directly deposit Federal payroll taxes, and electronically file Forms 941, Employer's Quarterly Federal Tax Return. She was also directed to open a corporate bank account (over which she had signatory authority) on behalf of Dey Corp, which she did. Later, when this account was frozen for unspecified reasons, she opened a second account at another bank where, when instructed to indicate she held some form of corporate office on the commercial signature card, she wrote "sec.," although she was never actually secretary for Dey Corp

When he was in Florida, Mr. Stamps oversaw day-to-day operations. But when he was in Trinidad, he was in constant contact with Kris Chislett, whom he hired as the general manager of the Grape. Mr. Stamps also monitored the Grape's bank balances and determined when it was appropriate to lend money to the business.

Mr. Chislett was responsible for carrying out the day-to-day business operations. He managed the employees, paid creditors, and oversaw purchases from vendors. He was responsible for hiring and firing personnel. Mr. Chislett was also Paychex's main contact during the periods at issue, and he maintained control over the payroll process.

Mrs. Fitzpatrick did not have a significant role at the Grape and was less involved once the business was operational. Her main responsibilities were delivering checks, relaying electronic bank account balances to Mr. Chislett, and delivering the business's mail that was sent to her private mailbox. Checks were delivered to her because the business did not open until late in the day; upon delivery of the checks, she was directed to sign the checks (because Mr. Chislett was off on payday and no one else onsite was available) and deliver them to the business premises. She was not responsible for and did not review statements included in the Paychex package. She also occasionally transferred funds to and from the corporate bank account and issued checks at Mr. Stamps's or Mr. Fitzpatrick's direction for some of the business's recurring monthly expenses. She made no operational decisions.

Expenses started to exceed revenue at the Grape, and checks to vendors bounced. After Paychex's attempt to withdraw funds for taxes was rejected by the bank, it ceased such attempts. Paychex continued to produce payroll checks and reference copies of Forms 941. The payroll checks and Paychex invoices for payroll services continued to be debited from the bank account. However, Paychex did not debit the payroll tax portion from the account, make payroll deposits on the business's behalf, or file Forms 941. Mrs. Fitzpatrick was unaware that these services had been cancelled.

IRS argued that Mrs. Fitzpatrick possessed all the recognized indicia of a responsible person. She exercised substantial financial control over Dey Corp and at all times she was a de facto officer of the corporation because she opened two corporate bank accounts, had signatory authority on those accounts, and signed about 81% of the payroll checks on behalf of the corporation. Mrs. Fitzpatrick argued that she lacked decision-making authority and did not exercise significant control over corporate affairs. Despite her signatory authority, she had a limited role in the business's payroll process and merely signed payroll checks for the convenience of the corporation.

The Tax Court determined that Mrs. Fitzpatrick was not a responsible person. Her role was ministerial; she did not hold corporate office, did not control financial affairs, had no ownership interest, had no authority to hire and fire employees, and otherwise had little or no decision-making power beyond ministerial duties.

While Mrs. Fitzpatrick signed most of the payroll checks prepared by Paychex, the duty was ministerial and done only for the convenience of the corporation. She had no duty to, and did not, oversee the employees, collect payroll information, compile payroll information, or remit the payroll information to Paychex on behalf of the corporation. Mr. Chislett was responsible for carrying out those duties.

While IRS characterized Mrs. Fitzpatrick as a savvy business person whose actions and prior work experience made her a de facto director, she only had a high school education and no experience in accounting, finance, tax, or management. She had no authority to hire and fire employees of the corporation. She had no responsibility to oversee or ensure the payment of payroll taxes on its behalf. She was not its bookkeeper or accountant. She did not reconcile the bank statements.

And even though she wrote and signed roughly 4% of the non-payroll checks to pay some of the corporation's recurring operating expenses (such as rent), she merely did so at the direction of others and for the convenience of the corporation. With the exception of a few weeks during the preopening phase, she had no involvement in the day-to-day affairs of the corporation and spent most of her time taking care of her severely disabled son, a task that negatively impacted her own health, resulting in infrequent contact with the corporation (sometimes no contact for a period months).

The Court found that Mr. Stamps and Mr. Chislett exercised control over the financial affairs of the corporation. Mrs. Fitzpatrick only served in a support function. Notwithstanding her signatory authority and her spousal relationship to one of the corporation's owners, she lacked actual authority.

While the Tax Court, having determined that Mrs. Fitzpatrick was not a responsible person, did not need to address the issue of willfulness, it did so. It found that she did not act willfully in failing to collect, account for, or pay over the trust fund taxes.

Mrs. Fitzpatrick had no knowledge that payroll taxes were unpaid. Mr. Chislett was Paychex's main contact and so responsible for ensuring Paychex provided adequate services. Mrs. Fitzpatrick merely delivered the Paychex package and any mail she received at her private mailbox to Mr. Stamps or Mr. Chislett at the business location. She neither reviewed nor was responsible for reviewing the mail or the contents of the Paychex package. Further, she did not have the responsibility to scrutinize the bank statements as IRS suggested. She did not reconcile the bank statements and had no oversight responsibility for the financial books and records of the corporation. She was merely directed to relay electronic bank account balances to Mr. Chislett and Mr. Stamps. Not until Dey Corp's CPA contacted Mrs. Fitzpatrick, several months after the business had been turned over to the franchisor, did she first learn that the corporation had not been making its payroll tax deposits.

Kenton R. Fleming, TC Memo 2017-155.

IRS properly mailed a deficiency notice to the taxpayer, despite the fact that IRS did not meet its own procedures when it failed to have a postmark on its certified mail list. It also held that taxpayer did not challenge his underlying liabilities during his collection due process (CDP) hearing and that he was liable for the §6673 frivolous position penalty.

If IRS determines that there is a deficiency in respect of any tax, IRS may send a notice of the deficiency to the taxpayer by certified mail or registered mail. (§6212(a))

§6320(a)(1) and §6330(a)(1) require IRS to give a taxpayer written notice when a Federal tax lien is filed upon the taxpayer's property or IRS intends to levy upon the taxpayer's property. The notice must inform the taxpayer of the right to request a CDP hearing in the Appeals Office (Appeals). If a taxpayer makes a timely written request and states the grounds for the requested hearing, the taxpayer is entitled to a fair hearing conducted by an impartial officer from Appeals. (§6320(a)(3)(B), §6330(a)(3)(B)) However, a taxpayer is precluded from contesting the existence or amount of the underlying tax liability at such a hearing unless the taxpayer did not receive a deficiency notice or otherwise have an opportunity to dispute the liability. (§6330(c)(2)(B))

After the administrative hearing is completed, Appeals issues a written notice of determination indicating whether the notice of Federal tax lien should remain in effect and/or the proposed levy may proceed. (§6330(c)(3); Regulation §301.6320-1(e)(3) Q&A E8; Regulation §301.6330-1(e)(3) Q&A E8)

A taxpayer may appeal an Appeals determination to the Tax Court within 30 days of the determination, and if an appeal is timely filed, the Court will have jurisdiction with respect to the matter. (§6330(d)(1), Regulation §301.6330-1(f)(1)) Courts consider a taxpayer's challenge to his or her underlying liability in a collection action case only if the taxpayer properly raised that challenge at the CDP hearing. (Regulation §301.6330-1(f)(2), Q&A F-3)

§6673(a)(1) authorizes the Tax Court to require a taxpayer to pay IRS a penalty in an amount not to exceed $25,000 whenever it appears to the Court that a proceeding before it was instituted or maintained primarily for delay (§6673(a)(1)(A)) or that the taxpayer's position in such a proceeding is frivolous or groundless. (§6673(a)(1)(B))

The taxpayer, Mr. Fleming, timely filed his 2005 individual income tax return showing zeros on all the income lines and claiming he was entitled to a refund of $5000. IRS did not process the Form 1040 but instead prepared a substitute return. IRS considered Fleming's Form 1040 to be a frivolous attempt to file a tax return and assessed a $500 frivolous return penalty against Fleming under §6702(a) ("Frivolous tax submissions"). In 2012, the Tax Court sustained the collection of that penalty.

IRS prepared a statutory notice of deficiency, dated August 12, 2009 that was addressed to Fleming's correct last known address. At trial, IRS placed into evidence a copy of the notice of deficiency. On the cover page of the notice of deficiency was a U.S. Postal Service (USPS) certified mail number. The record also included a copy of USPS Form 3877, Certified Mail List (Form 3877), dated August 12, 2009, which indicated that IRS sent an item of certified mail to Fleming on that date that bore an identical certified mail number. The address on the Form 3877 and on the notice of deficiency matched Fleming's address at that time and at the trial date. IRS's normal practice is to generate a Form 3877 only when mailing notices of deficiency. It also is IRS's normal practice to retain a copy of the Form 3877 bearing a dated USPS postmark in the records, but, contrary to that normal practice, the Form 3877 that was retained in this case did not bear a USPS postmark. A supervisory IRS agent overseeing issuance of statutory notices of deficiency in examination cases, who was familiar with IRS' procedure for issuing and mailing notices of deficiency and generating Forms 3877, gave the above information in her testimony.

The record did not include a copy of USPS Form 3811, Domestic Return Receipt (a "green card"), for the item. But Fleming did not always pick up certified mail sent by IRS when he received a green card notification.

In June 2011, IRS mailed Fleming a Notice of Intent to Levy. Fleming then submitted a timely request for a CDP hearing, in which he vaguely asserted that he had not received previous notices from IRS.

IRS Settlement Officer Harding sent Fleming a letter scheduling an administrative hearing via the telephone and inviting him to provide necessary financial information if he wanted to offer an alternative to the proposed levy (e.g., an offer-in-compromise or an installment agreement). Fleming did not contact Harding for the scheduled telephone conference. Harding then sent a second letter; Fleming responded that he did not intend to participate in a telephone conference.

IRS's Appeals Office then issued a notice of determination sustaining the proposed levy action. Fleming then petitioned the Court for review. The Court remanded the case to the Appeals Office. Harding invited Fleming to a face-to-face hearing and requested that he bring with him a properly completed 2005 Form 1040X, Amended U.S. Individual Income Tax Return, if he intended to challenge the assessment entered against him for that year. Despite a series of letters and voicemail messages, the parties did not have a further administrative hearing, and Fleming did not produce a properly completed 2005 Form 1040X.

The Tax Court held that, notwithstanding the lack of postmark, the notice of deficiency was properly mailed.

Fleming argued that the notice of deficiency was not sent to his last known address. The Court said that where a taxpayer identifies an irregularity in the assessment procedure, the settlement officer cannot rely solely on tax transcripts to verify that a notice of deficiency has been sent. Where a taxpayer alleges no notice of deficiency was mailed, he has identified an irregularity. In that case, the settlement officer is directed to examine underlying documents in addition to the tax transcripts, such as the taxpayer's return, a copy of the notice of deficiency, and the certified mailing list. The Court cited *Hoyle,* (2008) 131 TC 197.

The Court said that Fleming's sole evidence that the notice of deficiency was not properly mailed, and therefore was invalid, was his testimony that he did not receive the 2005 notice of deficiency and his testimony that he always picked up certified mail when he received a "green card" notification. The Court said that it did not find Fleming's testimony credible. Fleming admitted that on more than one occasion he did not pick up certified mail sent by IRS, contradicting his prior testimony. Thus, at most, Fleming's testimony established that he may not have picked up the notice of deficiency. The Court said that his testimony was not sufficient to undercut the actual evidence IRS offered at trial that the notice of deficiency was properly mailed to Fleming's last known address, including the incomplete Form 3877 and copy of the notice of deficiency each showing Fleming's last known address. While the lack of a USPS postmark on the Form 3877 in IRS's files means that IRS is not entitled to a presumption of mailing, the Court said that it found that the incomplete Form 3877 and the notice of deficiency in the record-along with the credible testimony of an IRS supervisory agent, who was familiar with the processing of notices of deficiency, that Forms 3877 are not created except when notices of deficiency are mailed-was sufficient to overcome Fleming's inconsistent testimony that the Court did not find credible.

The Court said that if it had accepted Fleming's testimony that he did not receive the properly mailed notice of deficiency, he would be entitled to challenge his underlying liabilities. The administrative record showed that he was given that opportunity and did not take it.

Fleming's failed to present evidence as to his correct tax liability or to provide requested financial information; this failure amounted to a failure to properly raise the issue of his underlying liability at the administrative hearing. Because Fleming failed to raise his underlying liability properly at his administrative hearing with Harding, he was not entitled to do so at trial.

The Court imposed a penalty of $5,000 and advised Fleming that greater penalties could follow if he persisted in taking frivolous and groundless positions and using Court proceedings for delay.

The Court noted that Fleming had been warned that he appeared to be taking positions that the Court had deemed frivolous or groundless or intended for delay. The Court had advised him that §6673(a)(1)(A) authorizes the Court to impose a penalty of up to $25,000 for frivolous and groundless arguments or when his actions were maintained primarily for delay. And, the Court said, he should have been aware of the possible consequences of his positions because the Court had imposed a frivolous penalty on him before.

Foxx, (Ct Fed Cl 2/6/2017) 119 AFTR 2d ¶ 2017-423.

The Court of Federal Claims has held that, where a tax preparer prepared a return that showed false income that enabled the taxpayer to take the earned income tax credit (EITC) and the taxpayer claimed that showing that income was strictly the preparer's idea, the §6694(b) willful or reckless conduct preparer penalty applied to the preparer, whether or not the taxpayer's claim was true, because the taxpayer provided inadequate documentation and the preparer did not request or examine proper documentation. The court also ruled against the preparer's claim that IRS should be sanctioned for its discovery request into whether the preparer had received a doctorate degree, as he claimed.

§6694(b) provides in relevant part that a penalty will be assessed on any tax return preparer who prepares a tax return "with respect to which any part of an understatement of liability is due to...a willful attempt in any manner to understate the liability for tax on the return or claim, or...a reckless or intentional disregard of rules or regulations."

Regulation §1.6695-2T requires preparers to perform due diligence before preparing tax returns that contain EITCs. This due diligence includes an obligation to "make reasonable inquiries if the information furnished to, or known by, a reasonable and well-informed tax return preparer knowledgeable in the law would conclude that the information furnished to the tax return preparer appears to be incorrect, inconsistent, or incomplete." The tax return preparer must also contemporaneously document in the files any inquiries made and the responses to those inquiries. (Regulation §1.6695-2T(b)(3)(i))

Under the Rules of the Court of Federal Claims, i.e., RCFC 26(b)(1), the parties generally may request discovery "regarding any nonprivileged matter that is relevant to any party's claim or defense and proportional to the needs of the case." However, RCFC 26(g)(1)(B)(ii) provides that a discovery request should not be made "for any improper purpose, such as to harass, cause unnecessary delay, or needlessly increase the cost of litigation."

In February 2008, Shakeena Bryant, accompanied by her friend Herman James, approached Dr. Foxx for assistance in preparing Ms. Bryant's 2007 tax return. Dr. Foxx did business as the "Tax Doctor." Ms. Bryant and Dr. Foxx had not met previously.

Ms. Bryant brought her W-2, which indicated that she had received a total of $15.51 in 2007 from a brief employment at Busch Gardens, and information regarding her children. She did not bring any documents indicating additional income. According to Ms. Bryant and Mr. James, Dr. Foxx told Ms. Bryant that she could nonetheless receive a tax refund if she reported additional income from a business.

Ms. Bryant applied for and received a business license for auto detailing and returned to Dr. Foxx's office that same day with the license. Dr. Foxx then prepared Ms. Bryant's tax return and reported $18,288 in business income from Ms. Bryant's purported auto-detailing business. As a result, Ms. Bryant qualified for earned income tax credits and received a refund of $2,577 from IRS. Ms. Bryant paid Dr. Foxx $169 as a tax preparation fee.

In 2009, IRS audited Ms. Bryant's tax return. In the course of that audit, Ms. Bryant stated that she had never owned an auto-detailing business. She told IRS that her 2007 tax return was incorrect, while also stating that she reported her false business income under the instructions of Dr. Foxx. IRS then contacted Dr. Foxx, who responded that he reasonably relied upon the statements of Ms. Bryant and exercised "due diligence" in preparing her return. IRS imposed a $5,000 tax return preparer penalty on Dr. Foxx pursuant to §6694(b) for his "willful or reckless conduct" in preparing Ms. Bryant's inaccurate 2007 tax return.

During fact discovery, IRS sent a subpoena to Nova Southeastern University to verify Dr. Foxx's claim that he had received a doctorate from that university. Dr. Foxx contended that IRS, through this subpoena, "sought irrelevant evidence," requested the "disclosure of privileged or other protected information," and hindered Dr. Foxx's ability to be hired by Nova Southeastern University in the future. The government responded that it reasonably sought "independent information about the legitimacy of plaintiff's claimed credentials and his credibility." Dr. Foxx sought sanctions against IRS regarding the subpoena.

The court held that the tax preparer penalty was justified under §6694(b).

Both Ms. Bryant and Mr. James stated that Ms. Bryant obtained a business license pursuant to Dr. Foxx's instruction. According to Mr. James, Dr. Foxx explained that such a license would allow him to obtain more money for Ms. Bryant, and Dr. Foxx, not Ms. Bryant, created the false business income that appeared on Ms. Bryant's tax return.

And, the court said, even if it were to adopt Dr. Foxx's account of the event, i.e., if it accepted that he possessed a good faith belief that Ms. Bryant had an auto-detailing business, Dr. Foxx intentionally or recklessly disregarded tax preparer rules and regulations. Under Regulation §1.6695-2T, Dr. Foxx was required to perform due diligence before filing Ms. Bryant's tax return for earned income tax credits. But in reporting more than $18,000 for Ms. Bryant's purported auto detailing business, Dr. Foxx did not examine any bank statements, business expense receipts, or business ledgers. He instead relied upon Ms. Bryant's business license, obtained the same day Dr. Foxx filed Ms. Bryant's return, and two pages of notes written by Dr. Foxx that outlined expenses associated with the business.

Dr. Foxx argued that his reliance on Ms. Bryant's alleged statements regarding her business was reasonable because Ms. Bryant otherwise would have only earned approximately $15 in 2007 based on the W-2 she provided to Dr. Foxx. The court said that such an argument was misplaced; Ms. Bryant's financial situation did not relieve Dr. Foxx of his obligation to make reasonable inquiries into any auto detailing business purportedly conducted by Ms. Bryant after she did not provide adequate documentation.

The court also said IRS's discovery request was permissible under RCFC 26 and that therefore sanctions were not appropriate.

Dr. Foxx informed IRS that he had obtained a doctorate degree from Nova Southeastern University. Dr. Foxx asserted that IRS's request sought irrelevant evidence and unnecessarily harmed him, but as a tax preparer who prepared an inaccurate tax return, Dr. Foxx's education and background were relevant. Further, Dr. Foxx disagreed with Ms. Bryant and Mr. James regarding the events in 2008 that led to the filing of the tax return at issue, and thus his credibility was relevant in the case. Dr. Foxx's veracity was especially significant because, per Ms. Bryant, his qualifications had been "questioned in the past" and he had "made extraordinary claims about other experiences." The government's decision to verify Dr. Foxx's degree independently, rather than merely to accept Dr. Foxx's statements, was therefore not for the improper purpose of harassing or harming Dr. Foxx. The government's request was relevant and appropriate because it was reasonably calculated to assist the court in assessing Dr. Foxx's education and credibility.

Gann, (Ct Fed Cl 3/21/2017) 119 AFTR 2d ¶ 2017-562.

The Court of Federal Claims has held that a company executive failed to establish that he did not willfully fail to pay trust fund taxes, where: a) the company remitted payroll taxes in an amount that exceeded the amount it withheld from its employees, but that was less than the sum of that amount and the employer's portion of the payroll taxes; and b) it did not designate how its payment should be applied to its tax liabilities.

§6672 imposes a penalty, the trust fund penalty, on any person who: (1) is responsible for collecting, accounting for, and paying over payroll taxes; and (2) willfully fails to perform this responsibility. The amount of the penalty is equal to the amount of the tax that was not collected and paid.

In determining whether an individual is a responsible person, courts consider factors including whether the taxpayer served as an officer of the corporation or a member of its board of directors, owned a substantial amount of stock in the company, participated in day-to-day management of the company, determined which creditors to pay and when to pay them, had the ability to hire and fire employees, or possessed check writing authority. Not every factor must be present; instead, a court must consider the totality of the circumstances to determine whether the individual in question had the effective power to pay the taxes owed.

Willfulness for purposes of §6672 includes a voluntary, conscious and intentional act to prefer other creditors over the U.S. (*Buffalow v. U.S.,* (CA 9 1997) 79 AFTR 2d 97-1540)

Internal Revenue Manual (IRM) §1.2.14.1.3 provides that "Any payment made on the business account is deemed to represent payment of the nontrust fund portion of the tax liability (e.g., employer's share of FICA) unless designated otherwise by the taxpayer."

Westerman (CA 8 2013) 112 AFTR 2d 2013-5040, held that IRS's right to apply payments in this way springs from a long-established common-law rule. "The law, with respect to the application of particular payments when the debtor owes distinct debts, has long since been settled...If [the debtor] neglects to make the application, the creditor may make it." (January, (S Ct 1813) 11 U.S. (7 Cranch) 572) Westerman went on to say "Seeing no reason today to abandon a rule which has stood the test of time, we join our sister circuits (*Schroeder,* (CA 7 1990) 65 AFTR 2d 90-998; *Emshwiller*, (CA 8 1977) 40 AFTR 2d 77-6094] in expressly holding IRS may allocate an undesignated payment among the payer's various tax liabilities as IRS sees fit."

In *Gann v. U.S.,* (09/16/2016 Ct Fed Cl) 118 AFTR 2d 2016-5800, the Court of Federal Claims held that Mr. Gann was a responsible person who willfully failed to perform his responsibility with respect to 2005 through 2007 payroll tax returns of HCI. HCI had made some payroll tax payments for those returns, and IRS had applied those payments first to HCI's non-trust tax liabilities and then to trust tax liabilities.

In the current case, Gann moved for reconsideration of the Claims court's earlier opinion. The basis of Gann's motion was that the payroll tax amounts paid to IRS by HCI for the fourth quarter of 2006 and the first and third quarters of 2007 exceeded the amounts withheld from employee pay during those quarters. This, according to Gann, was evidence of his subjective intent to pay at least the trust fund tax owed for those quarters. He argued that he therefore should not be subject to a penalty for willful failure to pay the trust fund tax owed for those quarters.

The court rejected Gann's new argument and thus upheld its earlier decision that he was liable for the trust fund penalty.

Gann argued that IRS's internal policies regarding how it applies payments when a taxpayer has a mix of past and current liabilities is a "gotcha" scheme that entraps the unwary taxpayer and inequitably results in the assessment of penalties. In Gann's view, the fact that HCI remitted sums necessary to meet the trust fund portion of tax obligations for particular quarters, notwithstanding that those payments were insufficient to meet the total tax owed for those quarters, should have been sufficient to prove him not willful for those periods. IRS's own decision regarding how it applies payments to outstanding liabilities should not form the basis of a finding of knowledge of a wrong action, for purposes of a penalty for willful failure to pay taxes.

Gann further argued that nothing on the Form 941s for 2005-2007 could have alerted him to the fact that IRS was going to apply the amounts paid over by HCI to non-trust fund liabilities first. A plain reading of those forms would reasonably have led Gann to conclude that HCI was paying more than the trust fund tax liability, he argued.

The court said that the fact that HCI remitted sums near or equal to the amount of trust fund tax for particular quarters does not change the general fact that HCI failed to stay current on its employment taxes during every quarter from 2005-2007. IRS lawfully applied payments consistent with its policy, and the result was a trust fund tax shortfall for the quarters challenged by the motion.

Citing Westerman, the court said that: a) IRS's policy of generally applying payments first to non-trust fund liabilities and second to trust fund amounts owed is no secret nor is it illegal; and b) it is also not a secret that a taxpayer may make an express election to pay trust fund liabilities first by making an explicit instruction to IRS. The fact that Gann made no election was not a defense, nor would it have been a defense if he was ignorant of that right.

The court also rejected Gann's argument that he made an implied designation by paying sums equal to or greater than the amounts withheld from employee pay. It cited Westerman's rejecting the argument that the timing and amount of a payment was sufficient to establish an express designation by the taxpayer.

In re Giacchi, (CA 3 5/5/2017) 119 AFTR 2d ¶ 2017-733.

The Court of Appeals for the Third Circuit has held that, except with respect to returns prepared with the assistance of IRS under §6020(a), debts for unpaid taxes from late-filed tax returns are not dischargeable in bankruptcy. In so doing, it affirmed district court and bankruptcy court decisions and also came to the same conclusion as the Appeals Courts in eight other circuits.

Section 727 of the Bankruptcy Code permits the discharge of debts in Chapter 7 bankruptcies, but contains a number of exceptions, including those in Section 523. (11 USC 727(b)) 11 USC 523 provides, in relevant part: "(a) A discharge under section 727...of this title does not discharge an individual debtor from any debt- (1) for a tax- (B) with respect to which a return, or equivalent report or notice, if required- (i) was not filed or given." For purposes of this rule, the term "return" means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes "a return prepared pursuant to §6020(a), or similar state or local law." The definition of "return" was added in 2005. (11 USC 523(a))

§6020(a) provides that, if a taxpayer fails to make a return but consents to disclose all information necessary for preparing the return, IRS may prepare the return.

The Courts of Appeal for the First, Fourth, Fifth, Sixth, Seventh, Ninth, Tenth and Eleventh Circuits (as well as several bankruptcy courts) have held that, unless a return is filed under §6020(a) or a state safe harbor rule similar to §6020(a), an income tax return filed late under applicable nonbankruptcy state law is not a return for discharge purposes. For example, see *Fahey v. Mass. Dep't of Revenue*, (CA 1 2015) 779 F.3d 1*; McCoy v. Mississippi State Tax Commission*, (CA 5 2012) 666 F.3d 924; *Mallo v. IRS,* (CA 10 2014) 114 AFTR 2d 2014-7022.

However, the Eighth Circuit, in *Colsen,* (CA 8 2006) 97 AFTR 2d 2006-2333, and various bankruptcy courts, have held that the "applicable filing requirements" language in 11 USC 523(a) refers to considerations other than timeliness, such as the form and contents of a return.

Bankruptcy courts had adopted a 4-prong test, previously developed in tax matters, to determine whether a document submitted to IRS constituted a "return" for purposes of 11 USC 523(a). This test, commonly known as the *Beard* test, comes from a Tax Court decision, *Beard,* (1984) 82 TC 766. The *Beard* test establishes the following four requirements for a document to serve as a tax return: (1) it must purport to be a return; (2) it must be executed under penalty of perjury; (3) it must contain sufficient data to allow calculation of tax; and (4) it must represent an honest and reasonable attempt to satisfy the requirements of the tax law.

The taxpayer, Mr. Giacchi, failed to file Forms 1040 for 2000, 2001, and 2002 in a timely manner. In 2004, IRS investigated and assessed a tax liability against Giacchi for 2000 and 2001. Approximately one month after IRS made those tax assessments, Giacchi filed Forms 1040 for 2000 and 2001. IRS assessed his 2002 tax liability in 2005, and Giacchi submitted a Form 1040 for 2002 in 2006. Based on information in the forms Giacchi filed, IRS abated a portion of the assessment it had made.

The bankruptcy court concluded that the tax debt in question was non-dischargeable under 11 USC 523(a) because Giacchi had failed to file tax returns for 2000, 2001, and 2002, and Giacchi's belatedly filed documents were not "returns" within the meaning of §523(a)(1)(B) and other applicable law. The district court affirmed. Giacchi appealed to the Circuit Court.

The Circuit Court, affirming the district court, held that Giacchi did not make "an honest and reasonable attempt" to follow the law and thus his tax liabilities with respect to the returns at issue were not discharged in bankruptcy.

The Court said that forms filed after their due dates and after an IRS assessment rarely, if ever, qualify as an honest or reasonable attempt to satisfy the tax law. This is because the purpose of a tax return is for the taxpayer to provide information to the government regarding the amount of tax due. If a taxpayer does not file a return, IRS is required to independently assess the taxpayer's liability, as it did when Giacchi failed to timely file his 2000, 2001, or 2002 tax returns. Once IRS assesses the taxpayer's liability, a subsequent filing can no longer serve the tax return's purpose and thus could not be an honest and reasonable attempt to comply with the tax law. Here, there was no dispute that Giacchi failed to file timely returns, and that, as a result of Giacchi's failure, IRS had to estimate his taxes without his assistance.

Giacchi made several arguments that his filings constituted tax returns. First, Giacchi argued that the tardiness of his filings did not render them any less of an honest and reasonable attempt to comply with tax law, relying on the Eighth Circuit's holding in Colsen that the "honest and reasonable attempt" inquiry focuses on the content of the form, not the circumstances of its filing. The Court here said that it declined to adopt the Eighth Circuit's approach and agreed with the weight of authority that the timing of the filing of a tax form is relevant to determining whether the form evinces an honest and reasonable attempt to comply with tax law.

Second, Giacchi asserted that, because his late-filed forms showed less tax liability and IRS abated the tax assessment based on those filings, the filings served a tax purpose and thus constituted returns. The Court said that this argument misses the point. Giacchi failed to provide IRS information to determine his tax liability so that IRS had to estimate his taxes without his assistance; Giacchi could not later seek to benefit from IRS's imprecise estimate. Giacchi's belated filings were merely self-serving bids to reduce his tax liabilities, rather than attempts to comply with the requirements and objectives of prompt self-reporting and self-assessment.

Finally, Giacchi argued that his delinquency in filing should be excused because of his "emotional state" during those years. The Court said that, although circumstances might demonstrate that a debtor, despite his delinquency, had attempted in good faith to comply with the tax laws, Giacchi's "emotional state" during the tax years in question was not such a circumstance.

Greenberg, (2016) 147 TC No. 13.

Attorney who represented a client before IRS in an administrative proceeding was not a "prevailing party" under §7430(a) and thus could not file a claim for litigation and administrative costs. Accordingly, the case was dismissed for lack of jurisdiction.

The Tax Court is a court of limited jurisdiction that may exercise jurisdiction only to the extent expressly provided by statute. (*Breman,* (1976) 66 TC 61) Historically, the issue of who is a proper party to file a petition is treated by the Tax Court as jurisdictional. (*Greenoak Holdings Ltd.,* (2014) 143 TC 170)

Under §7430, taxpayers who prevail against the U.S. in court or at the administrative level ("prevailing parties") may, subject to limitations, be awarded reasonable litigation and administrative costs. An IRS decision denying the taxpayer's request for reasonable administrative costs in whole or in part is subject to review by the Tax Court. (§7430(f)(2))

David Greenberg is an attorney who represented a taxpayer in an administrative proceeding before IRS pursuant to a power of attorney. He was owed fees for his representation that remain outstanding, and his client agreed that Greenberg would receive any administrative fees awarded under §7430.

On September 17, 2014, Greenberg sent IRS a letter applying for administrative costs under §7430 on his client's behalf. Then, on December 27, 2014, he sent another letter requesting the award of administrative costs on his own behalf. He discussed the matter with an Appeals officer who determined that costs should not be awarded. Greenberg filed his Tax Court petition on April 15, 2015.

In his petition, Greenberg originally argued that he was assigned the right to pursue the award by his client and therefore has the right to seek attorney's fees on his own behalf. However, he conceded this argument because assignment of a legal suit against the government is barred by the Anti-Assignment Act, 31 USC 3727(b). In his response, Greenberg clarified that he was pursuing the claim as it related to his own rights and not on behalf of his former client.

The Tax Court concluded that §7430(a) limits awards of administrative costs to "prevailing parties," and that Greenberg had no legal claim at stake in, and was not an actual party to, the underlying proceeding. Therefore, he was not the proper party to file a claim under §7430 and the Court lacked jurisdiction.

The Court looked to caselaw construing fee awards under §7430, as well as under 28 USC 2412, a fee-shifting statute under the Equal Access to Justice Act that similarly provides that a prevailing party may seek a judgment for attorney's fees. The Court found that cases applying both laws have required the prevailing party to actually be a party to the underlying proceeding based on the plain, unambiguous language of the term, and that attorneys lack standing to apply for fees thereunder on their own behalf. Further, §7430(a) refers to administrative costs "incurred by" the prevailing party-meaning, under its most natural reading, costs paid, not charged, by the prevailing party. Greenberg did not "incur" these fees; rather, he was their intended recipient. This reading found further support in caselaw that denied §7430 recovery to an attorney who represented himself and thus did not "incur" any fees for legal services. (*U.S. v. McPherson*, (CA 4 1988) 61 AFTR 2d 88-677)

Greenberg also argued that he was the "real party in interest," because he was contractually entitled to any award of administrative costs to his client, and as such had a right to claim administrative costs on his own behalf. The Tax Court, however, found that, regardless of whether or not he was the "real party in interest" did not alter its conclusion that Greenberg was not the "prevailing party" entitled to seek an award under §7430.

Groves v. U.S., (DC IL 05/05/2017) 119 AFTR 2d ¶2017-735.

A district court has determined that IRS's imposition of a §6700 penalty against an alleged tax shelter promoter was not barred on either limitations or laches grounds, even though the activity giving rise to the penalty had occurred more than a decade earlier. The court rejected the promoter's argument that the penalty is subject to the 3-year limitations period under §6501(a), finding that §6700 liability is not triggered by a taxpayer filing an inaccurate return and thus cannot be subject to a limitations period dependent on filing.

A promoter of an abusive tax shelter must pay, with respect to each proscribed activity, a penalty in the amount of the lesser of $1,000 or 100% of the gross income derived by that promoter. (§6700(a)) In order to establish a violation of §6700, IRS must prove that the promoter (i) was involved in an abusive tax shelter, and (ii) made statements about the tax benefits investors would receive if they participated in the shelter which the promoter knew or had reason to know were false or fraudulent. (*U.S. v. Raymond,* CA 7 2000) 86 AFTR 2d 2000-6196) §6671 provides that §6700 penalties "shall be paid upon notice and demand by the Secretary, and shall be assessed and collected in the same manner as taxes."

§6501(a) generally provides that a valid assessment of income tax liability may not be made more than three years after the later of the date the tax return was filed or the due date of the tax return. For purposes of §6501(a), a "return" is the return required to be filed by the taxpayer.

In May 2015, having determined that Phillip Groves unlawfully promoted certain transactions as tax shelters during the tax years 2002, 2004, and 2005, IRS assessed a $2.3 million penalty under §6700. IRS sent Groves a notice and demand for payment on October 15, 2015.

Groves paid 15% of the penalty and filed a refund claim with IRS, which IRS denied. He then filed a refund suit under §7422, challenging the timeliness of IRS's assessment. He claimed that assessment was barred by the 3-year limitations period under §6501(a) or the 5-year limitations period under 28 USC 2462, or that the assessment was barred by the doctrine of laches . The government, in turn, moved to strike the allegation in Groves' complaint that the penalty was barred on limitations and laches grounds. Federal Rule of Civil Procedure 12(f) provides that a district court may strike from a pleading "an insufficient defense or any redundant, immaterial, impertinent, or scandalous manner."

The court granted the government's motion to strike, finding that IRS's assessments were not barred on either limitations or laches grounds.

Groves argued that, because a tax assessment has a 3-year statute of limitations under §6501(a), and because §6700 penalties are "assessed and collected in the same manner as taxes," §6700 penalties are subject to §6501(a) 's 3-year limitations period and thus IRS's assessment in this case was untimely. The court concluded, however, consistent with other courts that have confronted this issue, that §6501(a) does not apply to §6700 penalties. Notably, §6501(a) depends on the filing of a tax return to begin the running of the limitations period, whereas §6700 assessments depend on engaging in prohibited activities (i.e., being involved in a tax shelter and making false statements about its benefits).

Alternatively, Groves claimed that IRS's assessment was untimely under 28 USC 2462, which provides a "catch-all" 5-year limitations period for "an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise." However, the court found that 28 USC 2462 does not apply to §6700 penalties because "action, suit or proceeding" implicates some sort of adversarial proceeding, but §6700 penalties are assessed prior to any such proceeding.

Finally, Groves argued that the legal doctrine of laches-under which a claim may be barred for "unreasonable" delay, even in the absence of a specific statute of limitations-prevents assessment of the §6700 penalties in this case. The court, looking to Seventh Circuit precedent (*U.S. v. Administrative Enterprises, Inc.,* (CA 7 1995) 75 AFTR 2d 95-843; *Lantz v. Commissioner,* (CA 7 2010) 105 AFTR 2d 2010-2780), found that laches does not bar assessment in this case. As a general rule, laches is not available against the government, and the limited situations in which it could possibly apply were not present in this case.

Harris, TC Summary Opinion 2017-21.

In a Summary Opinion, a divorced woman was entitled to innocent spouse relief with respect to a tax deficiency caused by erroneous deductions on her joint return that she filed with her ex-husband; she met the elements of §6015(c), and IRS did not demonstrate that she had actual knowledge that the deductions were erroneous.

Generally, each spouse filing a joint income tax return is jointly and severally liable for the entire tax due. (§6013(d)(3)) Nevertheless, an individual who has made a joint return may elect to seek relief from joint and several liability under, among other Code sections, §6015(b) or §6015(c).

§6015(b) provides full or apportioned relief from joint and several liability for tax to the extent that such liability is attributable to an understatement of tax. To be eligible for relief, the requesting spouse must establish that, in signing the return, he or she "did not know, and had no reason to know" of the understatement. (§6015(b)(1)(C)) A spouse seeking relief under §6015(b) has reason to know of the understatement if a reasonably prudent taxpayer in her position at the time she signed the return could be expected to know that the return contained the understatement. (*Hopkins,* (2003) 121 TC 73)

An election under §6015(c) treats the former spouses as if they had filed separate returns, and each spouse's liability is limited to that portion of the deficiency properly allocable to that spouse. (§6015(c)(1), §6015(d)(3))

Under §6015(c), a requesting spouse may elect to allocate a deficiency if the following four conditions are met: (1) a joint return was filed; (2) at the time of the §6015(c) election, the requesting spouse is no longer married to the nonrequesting spouse; (3) the requesting spouse elects the application of §6015(c) no later than two years after the date on which collection activities have begun; and (4) the deficiency remains unpaid. (§6015(c)(3)(A), §6015(c)(3)(B))

Relief under §6015(c) is not permitted if IRS is able to demonstrate that the requesting spouse had actual knowledge of "any item giving rise to a deficiency" that is not allocable to the requesting spouse. (§6015(c)(3)(C))

The taxpayer, Ms. Harris, married Mr. Harris in 1992.

In 2008, Mr. Harris purchased a 14.8-acre plot of undeveloped land with the intent of using it for a cattle ranching activity. Thereafter, he researched different types of livestock and their profitability, cultivated the land, and built a 6,000-square-foot barn on the 14.8-acre tract. Mr. Harris also kept and maintained the records for his cattle ranching activity. At no point was Ms. Harris involved in this activity.

At all times since they married, Ms. Harris worked actively as a real estate agent.

In 2011, the couple separated; they divorced in 2012. Upon their separation, Mr. Harris became the sole owner of the 14.8-acre parcel of property, including the barn.

Ms. Harris and Mr. Harris timely filed a 2011 joint Federal income tax return. Attached to the return were two Schedules C, Profit or Loss from Business. The first Schedule C related to Ms. Harris's realtor business (realtor Schedule C) and showed Ms. Harris as the sole proprietor. On the realtor Schedule C, Ms. Harris showed a net profit of $95,686. The second Schedule C related to the cattle ranching activity and showed Ms. Harris and Mr. Harris as the proprietors of a business named "Harris Stables" (Harris Stables Schedule C). The Harris Stables Schedule C reported gross income of $1,598, depreciation of the barn of $124,000, and a net loss of $133,277.

IRS determined a deficiency in the joint 2011 Federal income tax of $30,467, substantially all of which was attributable to the disallowance of various deductions claimed on the Harris Stables Schedule C. IRS treated Harris Stables as a hobby.

Ms. Harris requested relief from joint and several liability under §6015(b) and §6015(c) to the extent that the deficiency related to the disallowance of the Schedule C deductions.

The Court did not grant Ms. Harris relief under §6015(b). It noted that she acknowledged that before she consented to the filing of the return she reviewed it. Accordingly, the Court concluded that Ms. Harris knew, or certainly had reason to know, of the understatement.

But, it did grant relief under §6015(c).

First, it noted that the fact that the Harris Stables Schedule C showed both Mr. Harris and Ms. Harris as proprietors was belied by the fact that only Mr. Harris' cattle ranching activity was the subject of the Schedule C and by the further fact that at no point was Ms. Harris involved in that activity.

And, IRS did not dispute that the requirements of §6015(c)(3)(A) and §6015(c)(3)(B) were satisfied.

Looking to §6015(c)(3)(C), the Court said that it was IRS's burden to establish that Ms. Harris had actual knowledge of the erroneous deduction on the 2011 tax return. In determining whether a requesting spouse had actual knowledge of an improperly deducted item on the return, more is required than the requesting spouse's knowledge that the deduction appears on the return or that the former spouse operated an activity at a loss. A requesting spouse has actual knowledge of an erroneous deduction if the requesting spouse has knowledge of the factual circumstances that made the item unallowable as a deduction.

IRS disallowed the Harris Stables Schedule C loss deduction because the activity reported on the Schedule C was not, in IRS's view, engaged in for profit. Although Ms. Harris was aware of the cattle ranching activity, she did not participate in it in any way. IRS failed to demonstrate that Ms. Harris knew that Mr. Harris did not have the primary objective of making a profit.

Accordingly, IRS failed to establish that Ms. Harris had actual knowledge of the facts that caused IRS to disallow the claimed loss deduction resulting from the cattle ranching activity. Therefore, the Court held that Ms. Harris was entitled to relief from joint and several liability under §6015(c) for 2011 with respect to the disallowed Harris Stables deductions.

Haynes, (DC TX 6/15/2017) 119 AFTR 2d ¶ 2017-865.

A district court has rejected several arguments made by married taxpayers that they should not be subjected to the late-filing penalty, where their timely-filed electronically filed return was rejected by IRS because it had no entry in the field for the wife's social security number. One such argument was that a Supreme Court case on the issue, and several subsequent cases that relied on that case, were not precedential because they dealt with paper-filed returns, and electronically-filed returns are subject to requirements not applicable to paper returns.

A late filing penalty will be assessed if the taxpayer fails to timely file a return, unless that failure is due to reasonable cause and not due to willful neglect. (§6651(a)(1))

The Supreme Court, in *Boyle,* (S Ct 1985) 55 AFTR 2d 85-1535, held that reasonable cause may exist when a taxpayer relies on the "erroneous advice of counsel concerning a question of law." For example, reliance on an accountant or attorney's substantive advice on a matter of tax law, such as whether tax liability exists, or whether a taxpayer is required to file a return in a given year, is sufficient to show reasonable cause even if the advice is inaccurate. By contrast, reliance on an agent to ensure that a tax return is filed in a timely manner does not establish reasonable cause. Even when a taxpayer has retained another person to file his tax return, the ultimate responsibility to make certain that the return is timely filed belongs to the taxpayer. In *Denenburg,* (CA 5 1991) 67 AFTR 2d 91-368, the Fifth Circuit held that depending on accountants to take care of extensions and meet deadlines constitutes an unauthorized delegation of the taxpayer's responsibility to ensure timely filing of tax returns.

The taxpayers were Mr. and Mrs. Haynes; they hired Mr. Dunbar, a CPA, to prepare and file their federal individual income tax return for the 2010 calendar year. In the spring of 2011, Dunbar used the Lacerte software program to file for an extension of time to submit the Hayneses' 2010 income tax return, which was granted by IRS. On October 17, 2011, Dunbar attempted to use the Lacerte software program to electronically file the Hayneses' 2010 tax return. However, IRS rejected the attempted October 17, 2011 filing under error code 0242, based on the fact that the return listed Mrs. Haynes's social security number on the line designated for the employer identification number.

Dunbar advised Mr. Haynes that the 2010 tax return had been timely filed. Approximately eleven months later, IRS notified the Hayneses that it had not received their 2010 individual income tax return. In December 2012, Dunbar filed the Hayneses' 2010 tax return on paper.

IRS assessed a late-filing penalty against the Hayneses under §6651. The Hayneses paid the penalty and brought a refund suit in district court.

The Hayneses made several reasonable cause arguments, all of which were rejected by the court. Those arguments include:

a. That *Boyle* is limited to returns filed on paper. The Hayneses first argued that *Boyle* and several Fifth Circuit cases are paper filing cases based on the long standing principle that mere mailing of a return is filing. E-filing cases are different, they said, because there is the additional substantive requirement that the return not only be sent, but also received, and received in a format that is acceptable to the IRS Centralized computer - i.e., free of any of IRS's 98 page error codes. The Hayneses concluded that "a finding by this court that e-filing includes a new substantive requirement that may constitute reasonable cause, depending on the facts and circumstances of each case, is consistent with *Boyle*, the Fifth Circuit cases, and the long standing case law on penalty abatement."

The court looked to a Fifth Circuit case, *Fonteneaux,* (CA 5 2013) 112 AFTR 2d 2013-5905, which, it said, undercuts the Hayneses' argument that the so-called "additional substantive requirement" of "receipt of tax returns in a format acceptable to IRS" distinguishes e-filing cases and renders paper-filing cases inapposite. In Fonteneaux, the taxpayer submitted his tax return on paper and prior to the filing deadline, but his return was unsigned and, therefore, not properly filed. The Tax Court concluded, as did the Fifth Circuit, that the taxpayer lacked reasonable cause for his late filing and owed penalties under §6651(a)(1) as a result.

The court here said that the factual circumstances of Fonteneaux bear a pronounced resemblance to the matter at hand: a defective return, which otherwise would have been timely filed, and which was rejected by IRS and then re-filed after the due date. Fonteneaux illustrates that IRS must "receive" a tax return that conforms to its specifications when the return is filed on paper. Crucially, the same is true of tax returns filed electronically.

The court said that the Hayneses' argument, that something in the nature of IRS's "receipt" of electronically filed returns justified treating their case differently from paper-filing cases, took no account of the IRS rule mandating that electronic returns must meet IRS processing criteria before they are considered filed. The court referred to IRS Publication 1345, Handbook for Authorized IRS E-file Providers of Individual Income Tax Returns, ERO Duties After Submitting the Return to the IRS, which states that e-filed returns which "fail to meet processing criteria" are "consider[ed]...not filed" by IRS.

The court said that it could not discern any functional distinction between IRS's receipt of the defective paper tax return in Fonteneaux and IRS's receipt of the defective electronic filing in this case-"and certainly none that justifie[d] the upending of a rich line of precedent to carve out an exception for late electronically filed returns."

The court also noted that *Boyle* provided that "Congress intended to [create] an obligation to ascertain the statutory deadline and... meet that deadline, except in a very narrow range of situations." It said that, if it created an exception for late electronically filed returns as the Hayneses argued, it would have expanded the "very narrow range of situations" in which late-filing fees may be abated for cause.

b. That electronically filing by a professional is an act of providing legal advice. The Hayneses then asserted that "e-file complexity is not addressed in the 35 year old paper filing case of *Boyle*...but is more closely analogous to the reliance upon advice of [a] tax advisor." Elaborating on this idea, the Hayneses contended that the requirements to properly e-file a tax return are so complicated that only registered tax professionals can do so reliably and then only after rigorous training to satisfy the exhaustive requirements of their complex accounting software and meeting all of the regulations. The Hayneses concluded that "the tasks required to properly e-file a return are complex and substantive and therefore satisfy the reliance on the tax advisor exception." The Hayneses cited a variety of authorities in support of this position. IRS said that the Hayneses' argument lacked legal precedent and would be absurd: "such a rule would allow every taxpayer to evade...late-filing penalties merely by asking a tax professional to e-file...on their behalf."

The court said that Black's Law Dictionary defines "advice" as "guidance offered by one person...to another; professional counsel." It said that Dunbar was not offering "guidance" to the Hayneses on whether they should submit a tax return or whether they had any tax liability for the relevant year-the two examples contemplated in *Boyle*-when he prepared and electronically filed their tax return. He was performing a task on the Hayneses' behalf. The court said that, to find otherwise would mock the essential holding of *Boyle*, that the failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent. And, the court said, "surely a given act does not become substantive legal advice merely by virtue of its complexity."

The Hayneses also cited Internal Revenue Manual (IRM) 20.1.2.4.1, where IRS states that the failure-to-file penalty for partnerships is abatable upon a showing of reasonable cause if the partnership made a reasonable effort to meet the e-file requirement. The Hayneses argued that IRM 20.1.2.4.1 "acknowledges the difficulty of efiling and the reliance upon a registered e-filer to perform that complex task." But the court said that these rules apply only to partnerships with over 100 partners, which by law must file tax returns electronically or face steep fines. And, it said, while it appears that the IRM relaxes the reasonable-cause standard for large partnerships, the Hayneses failed to articulate why this standard should be extended to individual-person filers.

Taxpayer then cited two cases, *Gravett,* TC Memo 1994-156, and *Brown,* (DC TN 1985) 57 AFTR 2d 86-1483. In Gravett, the Tax Court found reasonable cause where a tax preparer filed a late return on behalf of a taxpayer after the tax preparer's grandson absconded with his car. The tax preparer had left the documents he needed to file the tax return in his car and was reluctant to call the police on his grandson.

In Brown, a district court concluded that the case of an elderly man deemed "incapable of meeting the criteria of ordinary business care and prudence" as well as "physically and mentally unable to comply... with the filing deadline for the estate tax return" fell within *Boyle*'s exception for "disability" as a "circumstance beyond [the taxpayer's] control."

The court said that it could discern no relationship between these two cases and the Hayneses' contention here: that "the tasks required to properly e-file a return are complex and substantive and therefore satisfy the reliance on the tax advisor exception." Indeed, the court said, these cases never address electronic filing.

And, the court cited the fact that 33,654,000 individual income tax returns were "self-prepared" and filed electronically in 2014. It said that the Hayneses' claim that only registered tax preparers can reliably file individual income tax returns electronically was "fatally undermined by these data."

c. That Lacerte's failure constituted reasonable cause. The Hayneses claimed that the alleged failure of the Lacerte software to provide notification of IRS's rejection of the tax return amounts to "circumstances beyond the taxpayer's control." "Clearly a software malfunction or failed transmission is beyond the taxpayers' control, whether it affects the taxpayers directly or affects the taxpayers through their agent."

The court noted that one plausible reading of *Boyle* allows for abatement of late-filing fees when circumstances beyond the control of the taxpayer-which the Supreme Court variously described as "incompetence or infirmity...disability" or objective incapacity to meet the requisite standard of ordinary care or prudence-prevent timely filing. But the court here said that an alleged software failure does not rise to the level of the Supreme Court's definition of a circumstance beyond the Hayneses' control-disability, infirmity, objective incapacity-in *Boyle*. Further, the Hayneses could have filed their tax return on paper, electronically, or selected any number of tax advisors to file a return on their behalf.

d. That Dunbar's representation that he filed the return created reasonable cause. The Hayneses contended that they were "reasonable in relying upon Dunbar's education, experience, reputation, historical performance, and representations that he had complied with IRS's complex efiling rules." But the court said that relying on an accountant's alleged erroneous representation that the return had been timely filed is effectively relying on the accountant to ensure a timely filing-precisely what *Boyle* drew a bright line to prevent.

High Desert Relief Inc., (DC NM 3/31/2017) 119 AFTR 2d ¶ 2017-621.

A district court has made several rulings regarding §280E, the Code section that disallows deductions in carrying on a trade or business that consists of trafficking in controlled substances. One such ruling was that §7609(c)(2)(E)(i), which provides an exception to the Code's third-party summons rules where the summons is issued by an IRS criminal investigator, does not apply when the summons is issued by a regular IRS agent to obtain information pertinent to enforcement of §280E.

While IRS has authority to require the production of a taxpayer's books and records that are in another party's possession, it's required to notify the taxpayer and certain others, who then may have the opportunity to intervene in a proceeding to enforce the third-party summons, or bring an action to quash the summons. (§7609(a)(1); §7609(b)) However, the requirement that the taxpayer receive notice of a third-party summons and the right of those persons to intervene in a summons enforcement proceeding or begin a proceeding to quash the summons do not apply to any summons issued by an IRS criminal investigator in connection with the investigation of an offense connected with the administration or enforcement of the internal revenue laws. (§7609(c)(2)(E)(i))

The district courts have jurisdiction to hear motions to quash third-party summonses. (§7609(h)(1))

To have a summons enforced, IRS must make a prima facie showing that: (1) the investigation will be conducted pursuant to a legitimate purpose; (2) the inquiry may be relevant to the purpose; (3) the information sought is not already within IRS's possession; and (4) the administrative steps required by the Code have been followed. (*Powell,* (S Ct 1964) 14 AFTR 2d 5942)

Once IRS makes its prima facie showing, the burden shifts to the party opposing the summons to either disprove one of the four elements of IRS's prima facie case or convince the court that enforcement of the summons would constitute an abuse of the court's process. The petitioner is only entitled to a hearing to examine an IRS agent if he or she points to specific facts or circumstances plausibly raising an inference of bad faith. (*Clarke,* (S Ct 2014) 113 AFTR 2d 2014-2483)

IRS is not permitted to issue an administrative summons when a Justice Department referral is in effect. (§7602(d)(1))

Several state legislatures have passed laws legalizing the cultivation and sale of marijuana. These laws have created a conflict between federal law and state law.

§280E provides that a taxpayer may not deduct any amount for a trade or business where the trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (e.g., controlled substances within the meaning of schedule I of the Controlled Substances Act-such as marijuana) which are prohibited by Federal law.

The taxpayer, High Desert Relief (HDR), operated a medical marijuana business in New Mexico.

IRS's auditor, Ms. Turk, on February 2, 2016, notified HDR by letters that IRS had selected for examination HDR's 2014 and 2015 tax returns. Ms. Turk attached Publication 1, "Your Rights as a Taxpayer," to each letter. In May and June, 2016, Ms. Turk issued a summons to: HDR's bank, My Bank; the New Mexico Department of Health - Medical Cannabis Program (NMDOH); and HDR's utility company, Public Service Company of New Mexico (PNM), requesting documents pertaining to HDR. Ms. Turk stated that she issued these summonses in order to assess the correctness of HDR's returns, determine if HDR has unreported taxable income, and substantiate the gross receipts reported in HDR's tax returns. When Ms. Turk served the summonses on PNM, My Bank and NMDOH, she mailed, the same day, via certified mail, copies of the summonses to HDR, along with a notice explaining HDR's rights to bring a proceeding to quash the summonses.

It was undisputed that no Justice Department referral, as defined by §7602(d), was in effect with respect to HDR for the 2014 or 2015 tax periods.

HDR filed petitions to quash the third-party summonses. Its primary argument in its petitions was that IRS was abusing its civil audit power to conduct a criminal investigation into whether HDR was violating the Controlled Substances Act (CSA). HDR also took the position that IRS cannot make any determination that an entity is illegally trafficking in drugs for purposes of §280E. HDR also argued that IRS cannot satisfy the requirements of Powell.

IRS filed a motion to dismiss HDR's petition on several grounds including that the court did not have jurisdiction over the subject matter because IRS had not waived immunity.

IRS did not support its argument that it had not waived immunity, but the court assumed that IRS's position was that §7609(c)(2)(E)(i) applied so as to prevent HDR's ability to avail itself of §7602(b) relief. And, the Court rejected that argument.

More specifically, the court assumed that IRS's position was that, if HDR's argument was that IRS was conducting a criminal investigation was correct, the court lacked jurisdiction because §7609(c)(2)(E)(i) expressly excludes from its waiver of sovereign immunity any third-party summons "issued by a criminal investigator of IRS in connection with the investigation of an offense connected with the administration or enforcement of the internal revenue laws."

The court said that, while §280E references a criminal statute, the CSA, it does not first require a determination by a government official conducting a criminal investigation that the party claiming a deduction is trafficking in controlled substances.

The court said that trafficking as used in §280E means to buy or sell regularly. As such, the real issue was whether IRS had authority to determine if, in the course of HDR's business, it regularly bought or sold marijuana. The court saw no reason why not. Such a determination does not require "any great skill or knowledge, certainly not skill or knowledge of a criminal investigatory bent." It cited *Alpenglow Botanicals, LLC,* (DC CO 2016) 118 AFTR 2d 2016-6968.

§280E instructs that deductions should be disallowed if certain circumstances exist in a taxpayer's business. As noted by the court in Alpenglow Botanicals, it "would certainly be strange" if IRS was not charged with enforcing that provision. The fact that selling marijuana may also constitute a violation of the CSA is simply a byproduct of §280E using the CSA's definition of "controlled substances." §280E does not require that a criminal investigation be pursued against a taxpayer, or even that §280E only applies if a criminal conviction under the CSA has been obtained. If Congress had wanted such an investigation to be carried out or conviction to be obtained, then it could easily have placed such language in §280E.

HDR asserted that §280E requires IRS to find that a crime has been committed and/or that a taxpayer has engaged in illegal activity. Even if these assertions were accurate, they do not transform IRS' determination that §280E applies into a criminal investigation. An IRS agent conducting a civil investigation into tax liabilities may investigate whether a party is violating the CSA for the purposes of applying §280E without conducting a criminal investigation.

Therefore, under §7609(b)(2), IRS waived sovereign immunity for this proceeding to quash, and, accordingly, the court had jurisdiction over the proceeding pursuant to §7609(h)(1).

The court then held that IRS made its prima facie case under Powell regarding the summonses and that HDR did not make the resulting case for bad faith.

Ms. Turk declared that the purpose of the investigation was to examine "the federal tax liabilities... of High Desert Relief, Inc....for the tax periods ending June 30, 2014, and June 30, 2015." The court said that this statement was enough to meet the first factor.

Ms. Turk also explained the summoned documents' relevance to the inquiry. She stated that the records from NMDOH would be used to determine whether HDR was growing or selling marijuana and where its growing facilities were. The records from PNM would be used to determine, from how much electricity HDR used, how much marijuana HDR grew during the inquiry period to substantiate gross receipts. And the documents from My Bank would be used to substantiate gross receipts income for the inquiry period. This information satisfied the second Powell factor.

Ms. Turk declared that the information she sought was not already in her possession and that HDR had not provided any documents in response to the information document request she submitted to HDR. She also stated that, after issuing the summons to PNM, she received a package from PNM in response to the summons but "I have not and will not open the package until this litigation is resolved." My Bank did not produce any records, but Ms. Turk obtained information from NMDOH through a public records request, and therefore she testified that IRS no longer sought to enforce that summons as it was moot. Through these statements, IRS met the third Powell factor.

The fourth Powell factor was satisfied by the mailings that IRS had made. Thus, IRS made its prima facie case.

HDR attempted to rebut IRS's showing of good faith. Most of HDR's arguments were premised on its position that IRS may not investigate or determine whether HDR violated the CSA. The court said that because it disagreed with this position, above, it need not revisit this issue here.

HDR also argued that it offered to provide IRS with the documents IRS sought and that, therefore, IRS could not meet the second Powell requirement that the information it sought was not in its possession. Prior to the issuance of the summonses, HDR offered to "furnish documentation to support income, costs of goods sold, and, ordinary and necessary business expenses, provided that we are given assurance from IRS, that IRS will use the information furnished for this civil audit, and not to support IRS's determination that the Taxpayer's business consists of illegal activities." An IRS attorney responded that IRS did not have the authority to agree to the conditions, citing §6103(i) ("Disclosure to Federal officers or employees for administration of Federal laws not relating to tax administration"), which requires IRS to turn tax return documents over to other agencies in some circumstances. The record did not reflect that HDR ever provided the documents to IRS, either before or after the summonses were issued. The court concluded that IRS had demonstrated it met that "the information sought is not already within the Commissioner's possession," the third Powell factor. HDR's response was insufficient to rebut IRS's showing, given that HDR only offered to produce documents (and not necessarily the specific documents summoned) upon conditions with which IRS could not lawfully agree.

The court then concluded that HDR had not met the Clarke standard regarding an inference of bad faith and held that therefore HDR was not entitled to a hearing in which it could examine Turk.

Finally, the court rejected taxpayer's argument that, because the Justice Department had issued memoranda in 2009 and 2013 that prosecution of marijuana related crimes committed by persons acting in compliance with state law was not a priority and was not to be pursued by the Department of Justice, the CSA was a "dead letter"-i.e., an unenforced law-and therefore it would be inequitable to enforce §280E.

HDR cited *Sterling Distributors, Inc. v. Patterson*, (DC AL 1964) 15 AFTR 2d 461, where the issue was the deductibility of some business gifts that were illegal under a state law that was not enforced, and the court allowed the deduction. The Sterling court said that it did not make sense to say that the gifting frustrated state public policy when it’s authorized officers long ago determined that the rule should not be enforced. HDR also cited other similarly decided cases.

In disagreeing, the court first noted that, to be deductible under §162, an expense must be ordinary and necessary to carrying on the taxpayer's business. A finding of "necessity" cannot be made, however, if allowance of the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof. Next, the court found that the cases that HDR cited all involved deductibility under §162; they did not involve §280E. §162 sets forth the general rule that ordinary and necessary business expenses are deductible, and then sets forth exceptions. One exception is for "other illegal payment under any law of IRS, or under any law of a State (but only if such State law is generally enforced)." (§162(c)(2)) §280E contains no such exception for the lack of enforcement of the CSA by either state or federal authorities. "Where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion."

Hodges, (CA 10 4/10/2017) 119 AFTR 2d ¶ 2017-653.

The Court of Appeals for the Tenth Circuit, affirming a district court opinion, has: 1) determined that the temporary manager of several nursing homes was liable for the trust fund recovery penalty under §6672; and 2) rejected the taxpayer's arguments that tax liens resulting from the assessment of the penalty were invalid.

§6672 imposes a responsible person penalty (aka trust fund recovery penalty) on any person who: (1) is responsible for collecting, accounting for, and paying over payroll taxes; and (2) willfully fails to perform this responsibility. The amount of the penalty is equal to the amount of the tax that was not collected and paid.

Willfulness for purposes of §6672 includes a voluntary, conscious and intentional act to prefer other creditors over the U.S. Thus, if a responsible person knows that withholding taxes are delinquent, and uses corporate funds to pay other expenses, such failure to pay withholding taxes is deemed "willful." (*Mazo v. U.S.,* (CA 5 1979) 43 AFTR 2d 79-853, *Thibodeau v. U.S.,* (CA 11 1987) 60 AFTR 2d 87-5763)

A federal tax assessment against a person automatically creates "a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person." (§6321) And, by operation of law, the liens arise "at the time the assessment is made and shall continue until the liability for the amount so assessed (or a judgment against the taxpayer arising out of such liability) is satisfied or becomes unenforceable by reason of lapse of time." (§6322)

In May 2000, the Oklahoma Department of Health appointed the taxpayer, Rex Hodges, as temporary manager of four nursing homes. Under Oklahoma law, as temporary manager, Rex assumed operating control of the facilities and had sufficient power and duties to ensure that the residents of the facilities received adequate care. Rex was in charge of day-to-day operations and was responsible for depositing the employees' payroll tax withholdings to IRS and filing federal payroll tax returns. He also had check-signing authority on the payroll account and had authority to hire and fire employees.

Although the nursing homes' payroll processor sent him biweekly reports detailing the amount of payroll taxes that had been withheld from the employees' paychecks and instructions for making the deposits to IRS, Rex failed to pay the employees' withheld payroll taxes to IRS.

IRS determined Rex was a "responsible person" who willfully failed to pay over taxes in violation of §6672, and in February 2004, IRS began assessing penalties against Rex personally in the amount of the unpaid payroll taxes. Federal tax liens attached to Rex's interest in his property as of the dates of the assessments (beginning in February 2004). Rex and his wife, Lisa, had purchased real property in 1998 as joint tenants. On April 30, 2004, Rex transferred his interest in the property to Lisa by quitclaim deed. The pre-transfer liens totaled $329,578. Because IRS continued assessing penalties against Rex after the transfer, tax liens also continued to attach to the property after the transfer. IRS sent Lisa a Notice of Federal Tax Lien on January 26, 2015, identifying Lisa as Rex's nominee.

IRS sued Rex and Lisa to reduce the tax assessments against Rex to judgment and to foreclose its liens on their property. A district court ruled in favor of IRS. Rex appealed to the Circuit Court.

The Court found Rex liable for the trust fund penalty.

There was no issue as to whether Rex was a responsible person. As to willfulness, the Court noted that willfulness is satisfied if a responsible person, after being notified that withheld payroll taxes have not been paid, fails to investigate or correct the mismanagement. And, Rex agreed that his actions were willful for this purpose.

But, the Court also noted, citing *Finley,* (CA 10 1997) 80 AFTR 2d 97-6321, that the Tenth circuit recognizes a reasonable cause exception, whereby the willfulness requirement "can be negated by showing the responsible person had reasonable cause for failing to pay withholding taxes held in trust for IRS." The Finley Court held that a taxpayer could avoid liability only when "(1) the taxpayer has made reasonable efforts to protect the trust funds, but (2) those efforts have been frustrated by circumstances outside the taxpayer's control."

And, Rex argued that he had such reasonable cause. Rex claimed to qualify for the reasonable cause exception because: (1) of the "urgent necessity of caring for the nursing home residents"; (2) Gary

Kading, the owner of three of the four nursing homes for which Rex was appointed temporary manager, promised Rex he would pay the taxes; and (3) Rex relied on an Oklahoma statute regarding a nursing home owner's responsibility for costs.

The Court held that none of these arguments placed Rex within the reasonable cause exception.

As to his first argument, he claimed he would have had to close the homes and that hundreds of employees would have been let go if he had paid over the taxes. The Court said that Rex pointed to no evidence that could support a finding that he made reasonable efforts to protect the withheld taxes. And, it said, financial concerns do not constitute "circumstances outside the taxpayer's control." Virtually every violation of §6672 occurs because a business is in financial straits.

As to his second argument, the Court said that Rex willfully failed to remit federal payroll taxes because he was aware that the corporation had defaulted in its payment of employment taxes but nevertheless disregarded a known risk by relying on the assurances of others instead of doing more. Mr. Kading's alleged promises to pay the taxes fall well short of evidence that Rex attempted to protect the trust funds but was frustrated in his efforts.

Finally, Rex claimed he had reasonable cause because of an Oklahoma statute that was cited in the order appointing him as temporary manager. The statute provides: "If funds are insufficient to meet the expenses of performing the powers and duties conferred on the temporary manager, the temporary manager may borrow the funds or contract for indebtedness as necessary...If such advances are not repaid in full, any amount not repaid shall constitute a lien against any and all assets of any owner." The Court said that this statute says nothing about taxes, nor does it attempt to preempt §6672. Although the owner is liable for unpaid debt undertaken to meet expenses, the statute does not immunize a responsible person who, despite having the withheld payroll taxes available to pay IRS, willfully fails to do so without reasonable cause.

The Court then rejected Rex's argument that, because Lisa took the property without notice of the liens that attached to Rex's interest, she took the property free of that liability, and thus the district court erred in allowing IRS to foreclose.

The Court said that it was undisputed that IRS assessed the §6672 penalties on February 16, 2004, for $329,578. Under §6321 and §6322, these assessments immediately created a lien, and that lien survived the transfer of Rex's interest in the property to Lisa on April 30, 2004. Citing R*ussell,* (CA 10 2008) 102 AFTR 2d 2008-7337, the Court said that the transfer of the attached property did not affect the lien because no matter into whose hands the property goes, the property passes with the lien attached. Therefore, whether Lisa had notice of the pre-transfer liens did not affect IRS's ability to foreclose on them post-transfer.

And, the Court rejected the taxpayer's argument that the government violated the statute of limitations because Lisa did not receive the notice of nominee lien until January 26, 2015, eleven years after the first liens attached, and the "general rule is that an assessment of tax must be made within three years from the date a return is filed or the due date of the return, whichever is later."

But the Court said that the law does not provide that once an assessment has been made, it expires after three years. In addition, a notice of nominee lien is not an assessment.

Hunsaker, (DC OR 10/20/2016) 118 AFTR 2d ¶ 2016-5343.

A district court, reversing the holding of a bankruptcy court, has held that, despite IRS's violation of the bankruptcy code's stay blocking collection by creditors, the affected taxpayers could not collect emotional distress damages because the bankruptcy code waiver-of-sovereign-immunity provision did not apply.

11 USC 362(a), the bankruptcy automatic stay provision, blocks creditors from collection attempts with respect to the debtor if they are made outside of court-supervised reorganization proceedings. 11 USC 362(k) allows individual debtors injured by a creditor's willful violation of the automatic stay to recover "actual damages." 11 USC 106(a) provides that "sovereign immunity is abrogated as to a governmental unit to the extent set forth in this section with respect to...[§] 362..."

Mr. and Mrs. Hunsaker filed for Chapter 13 bankruptcy protection. Their filing triggered the automatic stay contained in 11 USC 362(a). The parties agreed that IRS violated the automatic stay. The Hunsakers sought damages for emotional distress that resulted from that violation.

The district court held, reversing the holding of a bankruptcy court, that sovereign immunity can only be waived by unequivocal, clear statutory language, that language did not exist here, and therefore an emotional distress award was not appropriate.

The court said, citing the Supreme Court in *Cooper,* (S Ct 2012) 132 S. Ct. 1441, that legislative history cannot provide a waiver that otherwise appears ambiguous in the text of the statute. In other words, the scope of the waiver must be clearly discernable from the statutory language. If the scope is unclear, courts must accept the interpretation most favorable to the federal government. The scope of any waiver of sovereign immunity is to be strictly construed in favor of the U.S.

And, it said that §106(a) clearly waives sovereign immunity for some claims under §362(k).

It then looked to the question of whether Congress intended "actual damages" to include claims for emotional distress. The bankruptcy court in *In re Dawson,* (CA 9 2004) 390 F.3d 1139, concluded that allowing emotional distress damages best fulfills legislative intent to protect debtors from excessive psychological and emotional harm.

The court here said that, therefore, "actual damages" in §362(k) includes emotional distress damages under some circumstances. Dawson did not address sovereign immunity, however, because the dispute there involved only private parties. That emotional distress damages are available against private parties does not automatically authorize them against the federal government. "After all, when it comes to an award of money damages, sovereign immunity places the Federal Government on an entirely different footing than private parties."

The Dawson court concluded the phrase "actual damages" was ambiguous, even given the text and context of §362(k) as a whole. And, under the rule of Cooper, the legislative history discussed in Dawson cannot waive sovereign immunity where the text of §362(k) otherwise remains ambiguous. Because the phrase "actual damages" is ambiguous, the court here said that it had to construe §362(k) in favor of immunity.

The Supreme Court's decision in Cooper also supports a limited reading of §362(k). Although Cooper specifically addressed the Privacy Act, not §362(k), the Supreme Court addressed essentially the same question: if a statute waives sovereign immunity for "actual damages," does that waiver include emotional distress damages? The Supreme Court answered no. In doing so, the Supreme Court identified multiple plausible readings of "actual damages," even given the particular context of the Privacy Act. In the context of §362(k), the phrase "actual damages" displays the same chameleon-like qualities found in the Privacy Act; there are multiple plausible readings of §362(k).

Therefore, the court said, it must accept the reading most favorable to the federal government, which excludes emotional distress damages.

Jaob, (DC MI 11/1/2016) 118 AFTR 2d ¶ 2016-5409.

A district court in the Sixth Circuit has held that a taxpayer's very scanty proof of mailing did not satisfy the statutory mailbox rule that applied in the Sixth Circuit or the common law mailbox rule that has been applied by other circuits.

In general, under sovereign immunity principles, the U.S. may not be sued without its consent. One way to establish the government's consent is via 28 USC 1346(a)(1), which vests jurisdiction in the federal district courts to hear suits for the recovery of an erroneously or illegally assessed or collected internal revenue tax. However, before a suit can be brought under this provision, a refund claim must have been "duly filed" with IRS under §7422(a).

§6511(a) provides that a valid claim for credit or refund of tax paid must be filed within three years from the time the return was filed, or two years from the time the tax was paid, whichever is later. Thus, meeting this deadline is a prerequisite to bringing a valid refund suit.

The common law "physical delivery rule" states that a tax filing is not complete until the document is "delivered and received." (*Miller,* (CA 6 1986) 57 AFTR 2d 86-928) Over time, two statutory exceptions (referred to by the court here, together, as "the statutory mailbox rule") were established: under §7502(a)(1), if a return arrives late but is postmarked before the due date, the postmark date is treated as the delivery date; and under §7502(c), registration or certification of a mailing containing a return is prima facie evidence of delivery, and the registration/certification date is the postmark date under the timely mailing-timely filing rule.

There is a split in the Circuit Courts as to whether the above statutory exceptions are the only exceptions to the physical delivery rule. The Second, Sixth and Federal Circuits have held that a taxpayer cannot use circumstantial or extrinsic evidence of mailing to create a presumption of delivery. (*Deutsch,* (CA 2 1979) 44 AFTR 2d 79-5063; *Miller,* (CA 6 1986) 57 AFTR 2d 86-928; *Davis,* (CA FC 2000) 85 AFTR 2d 2000-1029) But the Tax Court, as well as the Third, Eighth, Ninth, and Tenth Circuits, have held that absent contrary proof of a mailing irregularity, proof that a document was properly mailed and postmarked creates a rebuttable presumption that the document was delivered to and received by the addressee (the "common law mailbox rule"). (*Walden,* (1988) 90 TC 947; Philadelphia Marine Trade Assn-Int'l Longshoremen's Assn Pension Fund, (CA 3 2008) 101 AFTR 2d 2008-1759; *Wood,* (CA 8 1990) 66 AFTR 2d 90-5987; *Anderson,* (CA 9 1992) 70 AFTR 2d 92-5010; *Sorrentino,* (CA 10 2004) 94 AFTR 2d 2004-5904)

The taxpayers, Mr. and Mrs. Jacob, claimed that they timely filed their amended 2009 return that requested a refund, in December, 2011, but IRS denied ever receiving their refund claim. The only proof of mailing the Jacobs submitted was a copy of a cover letter drafted by their attorney dated December 1, 2011 addressed to IRS and a copy of a Form 843 entitled "Claim for Refund and Request for Abatement" signed by them. Neither the Jacobs nor their attorney submitted an affidavit attesting to the mailing of their refund request. At their depositions, the Jacobs testified that they had no recollection of filing an amended tax return for the tax year 2009.

The Jacobs brought suit in the district court, and IRS sought to dismiss their suit for lack of jurisdiction because their refund claim had not been timely filed.

The court concluded that the Jacobs did not meet either the statutory or common law mailbox rule and therefore dismissed their refund suit.

The court first noted that the Sixth Circuit has adopted a bright-line rule for determining when a tax claim or return is filed. The taxpayer must show actual physical delivery or fall within the two narrow statutory exceptions to the physical delivery rule established by Congress pursuant to §7502. And, it said that the Jacobs did not meet either of the exceptions. As IRS denied ever receiving the Jacobs' claim for a refund and there was no postmarked envelope to consider, §7502(a) did not apply to this case. And, it was undisputed that the Jacobs did not send their refund claim via certified or registered mail, so the second statutory exception did not apply to them either.

The Jacobs argued that the common law mailbox rules saved their claim. But the court said that the Sixth Circuit squarely rejected the same argument in the Miller decision and has reiterated numerous times its holding that the §7502 exceptions are exclusive and that no common law exceptions exist for proving the filing of a tax claim or return.

In one such Sixth Circuit case, *Carroll,* (CA 6 1995) 76 AFTR 2d 95-8115, the Court expressed dissatisfaction with the Circuit's prior conclusion that the common law mailbox rule, with its non-statutory presumption of delivery, does not apply to save a taxpayer's claim that he placed a return or claim in the ordinary mail. But it also recognized that "unless the Supreme Court or Congress should decide otherwise...Miller...will remain good law in the Sixth Circuit."

The court here said that, although Congress has not again spoken on the subject, regulations interpreting §7502 which comport with and thus, bolster, the Sixth Circuit's holding in Miller. See Regulation §301.7502-1(e). Those regulations stress that the abovementioned statutory exceptions are the only exceptions, stating that "no other evidence of a postmark or of mailing will be prima facie evidence of delivery or raise a presumption that the document was delivered." Given that Congress had expressly delegated to the Secretary of the Treasury the authority to regulate in this area, see §7502(b), the court said that it deems it appropriate to defer, under *Chevron, USA, Inc. v. Natural Resources Defense Council, Inc.,* (S Ct 1984) 467 U.S. 837, to the agency's reasonable interpretations of §7502.

It said that the decisions of the Third, Eighth, Ninth, and Tenth Circuits that came to the opposite conclusion all predated the above-quoted regulations, and, thus, their precedential value may be called into question.

Moreover, the court said, even if it were not bound by Miller and could consider extrinsic evidence to decide if the Jacobs timely submitted their refund claim, the facts presented here were insufficient to support the presumption that IRS received their refund claim in 2011. In *Maine Med. Ctr.,* (CA 1 2012) 109 AFTR 2d 2012-1562, the First Circuit analyzed cases where extrinsic evidence was sufficient to trigger the common law mailbox rule, and found that "at a minimum, the taxpayers in each of those cases offered testimony regarding actual mailing and some additional corroborating evidence." One of those cases involved testimony by the taxpayer's friend that she saw the taxpayer enter the post office and exit without the envelope; in another case, the taxpayer offered very specific testimony detailing the mailing which was corroborated by testimony from a postal service employee who had a specific memory of the interaction.

Here, there was no evidence regarding the mailing itself. The Jacobs, themselves, testified they had no recollection of mailing the refund claim for the 2009 tax year. Before the court was only a copy of the Form 843 and a cover letter from the attorney to IRS stating that the form was enclosed. There was not even any evidence regarding the mailing practices of the law firm in general, let alone the kind of detailed, specific, and corroborated testimony about the mailing of the tax claim in question as required by those courts recognizing a presumption of receipt under the common law mailbox rule.

Kardash, (CA 11 8/4/2017) 119 AFTR 2d ¶ 2017-5119.

The Court of Appeals for the Eleventh Circuit, affirming a Tax Court decision, has held that a taxpayer, who was both a minority shareholder and a high-level employee of a corporation from which the majority shareholders siphoned substantially all the cash without paying the corporation's income taxes, was liable for those taxes as a transferee with respect to money the taxpayer received from the corporation as dividends.

§6901(a) provides that IRS may proceed against a transferee of property to assess and collect the liability, at law or in equity, for federal income tax, penalties, and interest owed by the transferor. §6901(a) merely gives IRS a procedure to collect the transferor's existing liability. IRS may collect the transferor's unpaid tax from the transferee if an independent basis exists under applicable state law or state equity principles for holding the transferee liable for the transferor's debts. (*Frank Sawyer Trust of May 1992,* (CA 1 2013) 111 AFTR 2d 2013-1434, *Starnes,* (CA 4 2012) 109 AFTR 2d 2012-2326)) Thus, state law determines the elements of liability, and §6901 provides the remedy or procedure to be employed by IRS as the means of enforcing that liability. (*Ginsberg,* (CA 2 1962) 10 AFTR 2d 5134)

The Florida Uniform Fraudulent Transfer Act ("FUFTA") provides both constructive fraud and actual fraud provisions. One type of constructive fraud has the following elements: the debtor received less than "reasonably equivalent value" for the transfer; and the debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer. (Fla. Stat. Announcement Secs. 726.105(1)(b), 726.106(1))

Florida Engineered Construction Products Corporation (FECP) was in the concrete products business. During the years at issue, 2003-2007, four individuals owned all of FECP's stock: taxpayer Kardash owned 8.65%, Robb owned 1.13%, and FECP's president, Stanton, and its board chairman, Hughes, owned equal shares of the remainder. Kardash was an engineer in charge of FECP's operation. He was not involved in the company's financial affairs.

During the years at issue, the company paid no Federal income tax despite the fact that it had taxable income, and its majority shareholders fraudulently siphoned substantially all of the cash out of the company.

Until 2003, FECP had a bonus program under which Kardash earned significant compensation. His bonuses depended on his performance. FECP suspended the bonus program for 2003 and thereafter. Hughes and Stanton decided to give Kardash bonus "advances" (Advance Transfers) in 2003 and 2004. The advances would allow Kardash to continue his standard of living while the bonus program was suspended. Mr. Stanton told Kardash that he would eventually have to repay the advances. Kardash did not sign a loan agreement, and he never paid interest on the loans. FECP ultimately forgave the loans in 2009. The advances totaled approximately $550,000.

In 2005, 2006, and 2007, FECP paid dividends (Dividend Payments) to its shareholders based on the percentage of stock ownership. FECP issued Kardash Forms 1099-DIV, Dividends and Distributions, reflecting these amounts, and Kardash reported these amounts as dividends on his individual returns. The dividends paid to Kardash totaled approximately $3.5 million.

Until 2007, FECP was, at least ostensibly, a thriving business, but by the end of 2007 at the latest, it had become insolvent.

IRS determined deficiencies, penalties, and interest with respect to the company for 2003-2007 totaling more than $120 million, but the company could not pay the liability. IRS agreed to let FECP pay its liability in $70,000 monthly installments. However, under that agreement, FECP would take more than 150 years to pay off its full liability. In the meantime, IRS sought to collect as much of the liability as it could from other parties.

IRS, utilizing §6901, sought to recoup the advances and dividends that Kardash received from the company during the period.

In the trial at the Tax Court (*Kardash,* TC Memo 2015-51), IRS argued that the Advance Transfers and Dividend Payments were constructively fraudulent transfers under FUFTA because FECP did not receive any value from Kardash in exchange and FECP was insolvent or the transfers led to FECP's insolvency. Kardash argued that both the Advance Transfers and Dividend Payments were designed to replace his lucrative bonuses, which FECP had temporarily suspended in 2003. Thus, according to Kardash, the transfers were part of his compensation package and not fraudulent. In any event, Kardash reasoned, FECP did not become insolvent until 2006, meaning that any prior payments could not satisfy the insolvency element of constructive fraud. Kardash also argued that, FUFTA notwithstanding, IRS failed to exhaust all reasonable collection efforts against FECP before pursuing transferee liability against him, in violation of §6901(a).

The Tax Court rejected Kardash's exhaustion argument out of hand, reasoning that the existence of any exhaustion requirement depended upon state law, and FUFTA did not impose one. Although the Tax Court agreed with Kardash with respect to the Advance Transfers, reasoning that they were designed to replace FECP's prior bonus program, it held that the Dividend Payments were not compensation and therefore constituted actual or constructive fraud. The Tax Court further held that, despite the fact that FECP only became insolvent in 2006, Kardash's 2005 dividend payment could be grouped together with the 2005 dividend payments to Stanton and Hughes and considered constructively fraudulent because all of the payments "were part of a series of transactions that led to the insolvency of FECP."

The taxpayer appealed to challenge the treatment of the Dividend Payments.

The taxpayer made several of the same arguments that he made in the Tax Court, and the Circuit Court rejected all of those arguments.

The taxpayer again made the exhaustion argument. Looking to the "at law or in equity" language in §6901(a), the Court said that the existence of an exhaustion requirement in a transferee-liability claim depends upon the legal theory under which IRS brings its claim. If brought under federal equity, then exhaustion is required. If brought under state or federal statute, then the substantive law of the statute governs. §6901(a), as a purely procedural statute, permits both. Because the state substantive law in this case did not require exhaustion for liability to exist, the Court said that IRS was not required to exhaust remedies against FECP before proceeding against Kardash as a transferee.

The Court then said that, having concluded that Florida state substantive law governed the extent of transferee liability in this case, it then had to determine whether Florida law permitted IRS to establish transferee liability against Kardash. Looking to the elements of constructive fraud under FUFTA, the taxpayer argued: 1) FECP received value from his services in exchange for the Dividend Payments, and 2) the Dividend Payments should not be grouped together with the fraudulent transfers made to Stanton and Hughes in order to satisfy the insolvency requirement. The Court rejected both of these arguments.

Kardash first argued that the Dividend Payments were designed to replace FECP's defunct bonus program, and, as such, FECP received reasonably equivalent value from the services he provided in exchange. However, the Court said, it was undisputed that both Kardash and FECP characterized the transfers as dividends. FECP reported the transfers as dividends on its IRS Form 1099-DIV, and Kardash reported the transfers as qualified dividends on his tax returns. Kardash benefitted from this designation, too, paying a lower marginal rate on the distributed dividends than he would have paid if the transfers were reported as bonus compensation. Finally, like dividend transfers, these payments were based on Kardash's percentage of stock ownership in FECP. Based on this information, the Court found that FECP received no value in exchange for the dividends and that they were therefore constructively fraudulent.

Kardash next argued that the Tax Court erred by grouping his 2005 dividend payment with the 2005 dividend payments to Stanton and Hughes in concluding that the insolvency element of constructive fraud was also satisfied. In order to establish the insolvency element of constructive fraud under FUFTA, a claimant must show either that the debtor was insolvent at the time of the transfer or became insolvent as the result of the transfer. Although the language of the statute speaks in terms of a single transfer of property, courts have interpreted similar language to apply to a series of related transactions. See, for example, In re *Mussa*, (Bktcy Ct IL 1997) 215 B.R. 158.

The Tax Court had found that FECP became insolvent by January 2006, and neither party disputed that finding. Therefore, Kardash's argument concerned only the status of the 2005 dividend payment - it was undisputed that FECP's actual insolvency satisfied the insolvency element of constructive fraud for both the 2006 and 2007 dividend payments.

Kardash argued that because his 2005 dividend payment was small, both in relation to the dividends paid to Stanton and Hughes and in relation to FECP's total assets, the Tax Court erred in grouping them together and concluding that they were part of a series of transactions that led to FECP's insolvency. The Court said that Kardash's point was not without some merit. Taken by itself, Kardash's 2005 dividend payment seemed paltry in comparison to the fraudulent cash siphoning conducted by Stanton and Hughes and the impact that those payments had on the solvency of FECP.

But the Court said that the law does not instruct it to evaluate Kardash's 2005 dividend payment in isolation. Although Kardash was not privy to the machinations of Stanton and Hughes, his 2005 dividend payment was part of the same series of dividend payments that led to FECP's insolvency.

Kazazian, TC Memo 2017-135.

The Tax Court has determined that a taxpayer was not entitled to recover administrative and litigation costs relating to her claim for innocent spouse relief, where IRS initially denied that claim, then ultimately conceded it. The Court concluded that she was not a "prevailing party" under §7430, and that even if she were, she did not show that she actually incurred any costs litigating her claim.

A prevailing party may recover reasonable administrative costs and litigation costs incurred in a tax matter brought by or against IRS. (§7430(a)) Such an award may be made where the taxpayer: (1) is the "prevailing party"; (2) has exhausted administrative remedies within IRS; (3) has not unreasonably protracted the proceeding; and (4) has claimed "reasonable" costs. (§7430)

To be the "prevailing party," the taxpayer must have substantially prevailed with respect to either the amount in controversy or the most significant issue (or set of issues) presented, and must satisfy a net worth requirement. (§7430(c)(4)(A)

A party is not treated as the prevailing party if IRS establishes that its position was "substantially justified." (§7430(c)(4)(B)(i)) The position is substantially justified if it is "justified to a degree that could satisfy a reasonable person" and has a "reasonable basis both in law and fact." IRS's position can be substantially justified even if ultimately incorrect; and an IRS loss or concession does not render a position unreasonable. (*Maggie Mgmt. Co.,* (1997) 108 TC 430)

§6015(f) provides for equitable innocent spouse relief under procedures prescribed by IRS if, taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency and relief is not available to the requesting spouse under §6015(b) (regular innocent spouse relief; generally, where the requesting spouse did not know or have reason to know of the understatement) or §6015(c) ("proportional" relief for separated or divorced individuals; generally, where the tax is allocated between the spouses as if they had filed separately).

Revenue Procedure 2013-34, 2013-43 IRB 397, provides seven factors to consider in determining whether equitable relief is warranted: marital status, economic hardship, knowledge or reason to know, legal obligation, significant benefit, compliance with income tax laws, and mental or physical health. IRS also considers whether the requesting spouse was abused before the return was filed. (Revenue Procedure 2013-34)

During 2009, Nina Kazazian practiced law as a sole proprietor and owned rental real estate. She filed a joint Federal income tax return for 2009 with Michael Stackpool. This return was professionally prepared and filed on November 2, 2010. Included with the 2009 return was a Schedule C, Profit or Loss From Business, that reported income and expenses attributable to Ms. Kazazian's legal practice, and a Schedule E, Supplemental Income and Loss, that reported income, expenses, and losses attributable to her rental real estate activities. The 2009 joint return showed an overpayment of $38,502 and requested a refund, which IRS paid by depositing $23,612 into a bank account titled in Mr. Stackpool's name and $14,890 into a bank account titled in Ms. Kazazian's name.

Ms. Kazazian and Mr. Stackpool separated in August 2010 and divorced in 2011. For 2010, Ms. Kazazian filed her Form 1040, U.S. Individual Income Tax Return, as married filing separately, and for 2011 she filed her return as single. For each year, she reported the income and expenses of her law practice on a Schedule C and the income and expenses of her rental real estate activities on a Schedule E.

IRS audited the 2009 joint return and Ms. Kazazian's individual 2010 and 2011 returns. During the exam, both Ms. Kazazian and Mr. Stackpool requested innocent spouse relief under §6015 with respect to the 2009 return. In its examination report, IRS proposed disallowing a number of deductions that Ms. Kazazian claimed during the three years, imposing accuracy-related penalties, and denying both requests for innocent spouse relief. The parties then held a conference with an Appeals Officer (AO), who ultimately determined that many of Ms. Kazazian's claimed deductions should be allowed, conceded the penalty, and found that Mr. Stackpool was entitled to partial innocent spouse relief but that Ms. Kazazian was entitled to none. The AO reasoned that relief was not available under §6015(b) and §6015(c) because all of the erroneous items were attributable to and known by her, and that she did not qualify for equitable relief under §6015(f) because only one of the seven factors-marital status-weighed in her favor.

The AO also considered both Mr. Stackpool's and Ms. Kazazian's allegations of spousal abuse in their requests for innocent spouse relief, which were corroborated by, among other things, calls to the police and Mr. Stackpool's securing of a judicial restraining order against Ms. Kazazian. The AO concluded that any such abuse played no role in the preparation and filing of the 2009 joint return, reasoning that they had separated before then and Ms. Kazazian actively engaged with the preparer in preparing the return.

IRS sent a final Appeals determination denying Ms. Kazazian's request for innocent spouse relief, which she challenged in the Tax Court. However, before the trial date, the parties filed a stipulation of settled issues in which they agreed that she was entitled to relief under §6015(f). Ms. Kazazian then filed a motion for reasonable litigation and administrative costs under §7430.

The Tax Court concluded that IRS's position in this case was justified. IRS's denial of relief under §6015(b) was reasonable in light of the facts that Ms. Kazazian was directly involved in the preparation of the return and had actual knowledge of its contents, and the items that gave rise to the understatement were attributable to her. She also did not qualify for relief under §6015(c) because, since all of the erroneous items were attributable to Ms. Kazazian, they would all be allocated to her if she had filed separately.

The Court then turned to her entitlement to relief under §6015(f). Ms. Kazazian challenged the reasonableness of the AO's denial primarily on the basis of spousal abuse. The Court, however, stated that abuse is a relevant factor when it "undermines the requesting spouse's ability to reason independently and be able to do what is required under the tax laws," and that the AO reasonably determined that Ms. Kazazian failed to show that this was the case. (Revenue Procedure 2013-34) Notably, the couple had permanently separated three months before the return was filed, and Ms. Kazazian was actively involved in the preparation of the return. Overall, the Court found that the AO's determination had a "reasonable basis both in law and fact" and was substantially justified.

The Court also noted that, while IRS ultimately agreed to concede the case, a concession "does not by itself establish that the position taken is unreasonable." (Maggie Mgmt. Co.)

In addition, the Court found that, even if it were to conclude that Ms. Kazazian were the prevailing party, she failed to prove the amount of professional fees incurred in pursuing her claim for innocent spouse relief. She submitted a vague declaration seeking almost $25,000 in professional fees despite the fact that she prepared her petition herself, represented herself in Court, and was unable to show that she incurred any professional assistance costs that related to innocent spouse relief as opposed to relating to the underlying deductions that gave rise to the understatement.

Estate of Kirsch, (DC NY 7/13/2017) 120 AFTR 2d ¶ 2017-5058.

A district court has held that a taxpayer who suffered from a cognitive impairment nonetheless did not qualify under the "financial disability" rules to toll the statute of limitations with respect to her refund claim; she did not meet Revenue Procedure 99-21 's requirements with respect to two statements that had to be attached to her refund claim.

In general, a taxpayer must file a claim for credit or refund of tax within three years after filing the return or two years after paying the tax, whichever period expires later. (§6511(a)) §6511(b) limits the amount of a claimed credit or refund of an overpayment to the tax paid within the period, immediately preceding the filing of the claim, equal to three years plus the period of any extension.

The periods of limitation under §6511(a) and §6511(b) are suspended for any period of an individual taxpayer's life during which he or she is financially disabled. (§6511(h)(1))

An individual is financially disabled if he or she is unable to manage his financial affairs because of a medically determinable mental or physical impairment that can be expected to result in death, or has lasted (or can be expected to last) for a continuous period of not less than 12 months. A person is not financially disabled if "any other person is authorized to act on behalf of such individual in financial matters." (§6511(h)(2)(B))

And an individual is not considered financially disabled unless proof of the existence thereof is furnished in such form and manner as IRS may require. (§6511(h)(2)(A)) One such requirement is that a physician's statement containing specified information be submitted with a refund claim in order to claim financial disability. Among the items of specified information are: (a) the name and a description of the taxpayer's physical or mental impairment; and (b) to the best of the physician's knowledge, the specific time period during which the taxpayer was prevented by such physical or mental impairment from managing the taxpayer's financial affairs. (Revenue Procedure 99-21, 1999-17 IRB 18, §4(1))

Another such requirement is that the claimant submit a statement "by the person signing the claim for credit or refund, that no person... was authorized to act on behalf of the taxpayer in financial matters during the period described in [the physician's statement]." (Revenue Procedure 99-21, §4(2))

On June 5, 2014, Ms. Kirsch signed and filed a 2008 form 1040 that had been prepared for her. The return requested a refund.

Attached to the return she filed were two statements. The first statement was signed by her doctor, Dr. Mazzoni. It included the following:

"(1) Ms. Kirsch has been diagnosed with a cognitive mental impairment."

"(4) While first diagnosed on January 3, 2012, Ms. Kirsch first began reporting issues with her memory in 2007. Given the progressive nature of cognitive mental impairments, Ms. Kirsch would have begun to experience adverse effects of her mental impairment first in 2007 and it became progressively worse."

The second statement was signed by her son, Harold. It provided, "I was authorized to act on behalf of [Ms. Kirsch] in financial matters during the period described in Paragraph 4 of the statement from Dr. Mazzoni.... However, the durable power of attorney was only effective after April 1, 2009. I did not exercise such authority during that period described in Paragraph 4, referenced above, because I had no knowledge living on the west coast that my assistance and authority were required."

Ms. Kirsch died in 2016. The taxpayer in the case was her estate (the Estate).

Ms. Kirsch did not qualify as financially disabled because neither Dr. Mazzoni's statement nor her son's statement met the requirements of Revenue Procedure 99-21.

The court said that Dr. Mazzoni's statement merely stated that "Ms. Kirsch would have begun to experience adverse effects of her mental impairment first in 2007" (emphasis added by the court). It said that the statement in no way stated that, as of 2007, Ms. Kirsch was prevented from managing her financial affairs. While the statement provided a diagnosis date (January 3, 2012), as well as the year that Ms. Kirsch first began experiencing symptoms (2007), the statement provided no detail as to the specific time period of Ms. Kirsch's alleged financial disability - i.e., when she was prevented from managing her financial affairs by reason of a medical or mental impairment which could be expected to result in death or last for a continuous period lasting for not less than 12 months. Therefore, the statement failed to satisfy Revenue Procedure 99-21.

The Estate attached to its pleadings in the case a new statement from Dr. Mazzoni. The Estate asserted that this additional statement "would remedy, under all circumstances, any alleged technical deficiencies that may or could have existed with Dr. Mazzoni's original statement."

The court disagreed and said that the bulk of Dr. Mazzoni's supplemental statement pointed to possible memory issues beginning in 2007, but the statement, conspicuously, did not state the "specific time period" during which Ms. Kirsch was prevented from managing her financial affairs, as required by Revenue Procedure 99-21, §4(1). And the court said, even if Dr. Mazzoni's supplemental statement substantively complied with Revenue Procedure 99-21, it was procedurally deficient. Submitting a supplemental statement to a court is not sufficient to comply with the requirements of

Revenue Procedure 99-21, because the Revenue Procedure requires that the physician's statement be submitted with the claim for credit or refund.

The Estate next argued that Dr. Mazzoni's original statement substantially complied with, and therefore was sufficient under, Revenue Procedure 99-21. Where a claimant substantially complies, but fails to strictly comply, with the technical regulatory requirements under the Code, the doctrine of substantial compliance saves what would otherwise be a fatal error. See e.g., *Walter,* (DC PA 2009) 104 AFTR 2d 2009-7761, which found that substantial compliance with Revenue Procedure 99-21 was sufficient to establish tolling under §6511(h).

The Walter court found that even though a physician's statement failed to specifically state that the claimant was prevented from managing his financial affairs, the physician substantially complied with Revenue Procedure 99-21, §4(1). It said that the physician's statement was so detailed that the clear import of the statement was that the claimant's medical issue prevented him from managing his financial affairs.

The court here said that, in this case, by contrast, one could not deduce the dates of Ms. Kirsch's alleged financial disability from Dr. Mazzoni's statement. The statement provided the date of diagnosis (January 3, 2012), the year in which Ms. Kirsch started to report issues (2007), and that the symptoms became progressively worse. In no way was the "clear import" of the statement that Ms. Kirsch's symptoms were sufficient during a specific time period to toll the statute of limitations.

The court then went on to say that Harold's statement also was insufficient. Revenue Procedure 99-21 requires that a claimant must state that "no person...was authorized to act on behalf of the taxpayer in financial matters during the period described in [the physician's statement]." The court said that Harold's statement did the exact opposite-he stated "I was authorized to act on behalf of [Ms. Kirsch]." The Estate's argued that Harold's power of attorney was not actually effective under state law until he became aware that he had such authorization. The court dismissed this argument as irrelevant; what was relevant was that his statement was noncompliant.

Kiselis, (Ct Fed Cl 3/20/2017) 119 AFTR 2d ¶ 2017-551.

The Court of Federal Claims has held that a return that omitted large numbers of income items that IRS was aware that taxpayer earned, and that taxpayer knew that IRS was aware of, was not a return that qualified as a refund claim.

§7422 provides that no suit may be brought for the recovery of any tax alleged to have been erroneously or illegally assessed or collected until a claim for refund or credit has been duly filed with IRS.

Regulation §301.6402-3(a)(5) provides that "a properly executed individual... original income tax return or amended return shall constitute a claim for refund or credit... if it contains a statement setting forth the amount determined as an overpayment and advising whether such amount shall be refunded to the taxpayer." And, Regulation §301.6402-2(b)(1) provides that, for a return to constitute a refund claim, it "must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof..."

When the taxpayer, Mr. Kiselis, did not file his 2000 tax return, IRS used 1099 Forms-including several Forms 1099-B(Proceeds from Broker and Barter Exchange Transactions)-that it received from nine financial institutions who paid Kiselis income for 2000, to create a Substitute for Return(SFR) for 2000. Thereafter it assessed tax based on the SFR, levied on several of Kiselis's financial institution accounts, and collected over $60,000 via levy.

Many years later, on January 9, 2013, Kiselis filed a 2000 return on which he reported $800 of gross income from interest and ordinary dividends and nearly $50,000 in business expenses, and requested a refund of $46,679.17.

When IRS denied the refund, Kiselis sued for a refund in the Claims court.

The Court found that the January 9, 2013 return was not a valid refund claim for purposes of §7422 and that therefore it had no jurisdiction to hear Kiselis's case.

The Court said that, although nine financial institutions provided IRS with information relating to Kiselis' investment income for 2000, Kiselis failed to attach a Schedule D. Kiselis provided no information regarding distributions from third-party financial institutions. By filing such an incomplete return and failing to attach a Schedule D, Kiselis failed to include sufficient data for to calculate his tax liability as required by the reg.

It is not enough for a form to contain some income information required by the Code. The fact that IRS may have been able to piece together what Kiselis should have reported in a Schedule D using the Forms 1099 submitted by financial institutions did not render Kiselis's tax return valid. Kiselis was obligated to provide that financial information to IRS in his return.

To be a valid tax return for purposes of a refund claim, the return must "evince an honest and genuine endeavor to satisfy the law."(*Zellerbach Paper Co.* (S Ct 1934) 14 AFTR 688) Here, Kiselis was aware of the tax liability IRS had assessed based on distributions reported by third-party financial institutions, but failed to report this on his Form 1040. As such, Kiselis failed to exhibit an honest and reasonable intent to provide the requisite information.

Because the Form 1040 Kiselis submitted to IRS did not constitute a valid return, Kiselis did not submit a proper refund claim to IRS, and so the Court lacked jurisdiction.

Knowles, TC Memo 2017-152.

The Tax Court found that a psychiatrist, who filed late individual returns for some years, failed to substantiate deductions, under-reported income, claimed an incorrect filing status, made intentional misstatements and proffered misleading forged documents to IRS, was liable for the fraud penalty for two out of the five years for which it sustained deficiencies. The Court also imposed other penalties, including failure-to-file and accuracy-related penalties, for some years.

For the years before the Court (2008-2012), Margaret Knowles was a psychiatrist who practiced through 2010 as an independent contractor for Associates in Psychiatric Medicine (APM) in Illinois, and, during 2011 and 2012, as a salaried employee of Ministry Medical Group in Wisconsin. Knowles' contract with APM provided her with office space, office furniture, and administrative support services, including billing to patients and insurance companies. APM collected all proceeds from patients Knowles treated at APM's offices, keeping 40% and distributing the remaining 60% to her. Each year APM issued Knowles a Form 1099-MISC, Miscellaneous Income, for the fees distributed to her.

Knowles reported expenses related to the APM contract totaling $143,573, $155,703, $224,432, and $11,599 for tax years 2008-2011, respectively, on her schedules C (the claimed 2011 expenses related to services she rendered at APM's offices in 2010 but was not paid for until 2011). She reported gross receipts of $214,888, $261,629, $314,237, and $10,384 for tax years 2008-2011, respectively. For tax year 2010, she reported $195,430 as office expenses, of which IRS allowed a deduction for $142,249.

Knowles' salary at Ministry Medical Group in 2011 and 2012 was $200,000 per year. She provided Ministry with a temporary address in Wisconsin and entered into a relocation assistance agreement with Ministry in 2010. She submitted expenses to Ministry for temporary housing, substantiated with checks for rent and a security deposit made out to her mother-in-law. During early January 2011, Knowles and her husband lived at her mother-in-law's lake house in Wisconsin. Knowles provided Ministry a false rental agreement, when she and her husband were not charged any rent for the house.

Since childhood, Knowles was an amateur horsewoman. She operated Big Dog Farms (BDF) from 2005 to 2011 for the purpose of breeding, selling, and showing horses. She did not maintain a separate bank account for BDF, which reported annual losses ranging from about $30,000 to $149,000, and totaling about $582,000. For the years at issue, Knowles reported gross receipts totaling under $1,400, combined.

On her returns for 2011 and 2012, Knowles claimed Schedule A itemized deductions for real estate taxes and charitable contributions, and for 2011, unreimbursed employee business deductions, all of which IRS disallowed.

In 2008, Knowles deposited checks for $3,000 and $2,000 into her personal checking account; in 2009 she deposited four checks for totaling $3,727 into the account. She did not report any of these amounts as income.

Knowles got married in January 2011 and had her husband covered under her employee medical plan, making payroll contributions consistent with spousal coverage. In October of 2013, she submitted a benefits change form removing her husband from the plan effective January 1, 2014, and in December 2014 removed him as beneficiary of her life insurance policy. Knowles filed her 2011 and 2012 returns as a single filer. On audit, she produced questionable documents showing that she had divorced her husband in late 2011, but the court that the documents purportedly came from had no record of the divorce. The divorce petition also included her husband's seemingly forged signature. Court documents related to a divorce petition filed by Knowles' husband indicate their separation as occurring in September 2014. The Tax Court found that Knowles' correct filing status for 2011 and 2012 was married filing separately.

Knowles did not file her 2008-2010 returns until August 2011, December 2011, and March 2012, respectively. Her 2011 and 2012 returns requested refunds of about $41,000 and $8,500.

IRS issued numerous information document requests and one summons to Knowles. The revenue agent had difficulty setting up a meeting with her. It took approximately 10 months to schedule a meeting. Meetings were often rescheduled or postponed. Knowles did not provide the agent with documents that would support the returns. She also told the revenue agent that she filed her 2008 return late because of the death of her father in 2009, when her father died in April of 2008.

The Court sustained IRS's disallowance of expense deductions related to Knowles' medical practice at APM. She offered no testimony regarding their relationship to her work and no substantiation of expenses related to car and truck expenses, utilities, office expenses, answering service expenses, supplies, and legal and professional expenses.

After considering applicable facts and circumstances, including most notably the manner in which the activity was carried on, the history of income or loss, and Knowles' financial status, the Court also concluded that Knowles did not operate BDF with the actual and honest objective of making a profit. It disallowed the expense deductions for BDF that she reported on her Schedules C for 2008-2011. The Court also sustained IRS's disallowance of Knowles' itemized deductions for lack of substantiation, and in the case of claimed unreimbursed employee business expenses, for failure to show that the expenses were not reimbursable by her employer. The Court also agreed with IRS that checks deposited into Knowles account constituted unreported income, since she offered no evidence to show that they were not.

IRS sought to impose fraud penalties for Knowles' tax years 2010-2012. Under §6663, if IRS establishes that any portion of an underpayment is attributable to fraud, the entire underpayment is treated as attributable to fraud and subject to a 75% penalty, unless the taxpayer establishes that some part of it is not attributable to fraud. The Court cited numerous cases for the proposition that fraudulent intent may be inferred from various kinds of circumstantial evidence, or "badges of fraud," including, but not limited to, the consistent understatement of income, filing false documents (including false income tax returns), engaging in illegal activities, concealing assets, engaging in extensive dealings in cash, implausible or inconsistent explanations of behavior, inadequate records, and failure to cooperate with tax authorities.

The Court did not sustain the fraud penalty for 2010 for over $53,000 of disallowed business deductions. Despite her lack of substantiation, the Court noted that IRS allowed a great many of Knowles' claimed deductions for that year, and there was not clear and convincing evidence that she had fraudulent intent regarding the unsubstantiated expenses. Knowles was, however, held liable for the accuracy-related penalty under §6662(a) for those years for her failure to maintain adequate records and failure to report income without any showing of reasonable cause.

Regarding 2011 and 2012, however, the Court found sufficient indications of fraud to impose the penalty, including:

a. Filing false documents with IRS (filing as single while actually married, and providing IRS with fraudulent divorce documents);

b. A pattern of overstating deductions, along with implausible and unpersuasive explanations;

c. Giving inconsistent testimony that was not credible; and

d. Instances of fraudulent behavior against others in a business transaction (e.g., giving a false rental agreement and false rent checks to employer).

Lyerly, (DC AL 11/3/2016) 118 AFTR 2d ¶ 2016-5427.

A district court, while acknowledging that IRS made numerous errors in assessing the taxpayers' tax and applying their tax payments, rejected all of the taxpayers' arguments for relief. But it also rejected IRS's motion for summary judgment regarding its assessment of a late filing penalty, finding that there were issues of material fact as to the presence of reasonable cause.

The United States, as sovereign, is immune from suit except as it consents to be sued. (Sherwood, (1941) 312 US 584) 28 USC 1346(a)(1) provides, in relevant part: "The district courts shall have original jurisdiction...of...any civil action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority."

A taxpayer may also sue for the sum of actual, direct economic damages sustained as a proximate result of the reckless, intentional or negligent actions of an IRS officer or employee (§7433(b)) in connection with the collection of any Federal tax. (§7433(a))

§6501(a) generally provides that a valid assessment of tax liability may not be made more than three years after the later of the date the tax return was filed or the due date of the tax return.

In *Lewis v. Reynolds,* (1932 S Ct) 10 AFTR 773, the Supreme Court held that no refund or credit may be made unless it has first been determined that a taxpayer has made an "overpayment" of tax for the relevant taxable period. The term overpayment has been interpreted as meaning any payment in excess of that which is properly due. In Lewis, the Supreme Court upheld IRS's authority to retain payments already received when they do not exceed the amount which might have been properly assessed and demanded.

Estoppel is the judicial principle that precludes a person from asserting something contrary to what is implied by a previous action or statement of that person or by a previous pertinent judicial determination.

Unless it is shown that a failure to timely file a return is due to reasonable cause and not due to willful neglect, a 5% per month penalty applies. (§6651(a)(1))

The taxpayers were Rick and Sharon Lyerly. Rick was an attorney with a general practice. Rick suffered from many health problems including panic attacks and anxiety tied to dealing with financial matters. Because of this anxiety, Rick relied almost entirely on others to take care of his financial matters, including filing his tax returns. He delegated this responsibility to his accountant, Mr. Hill, and various office managers that he employed. Rick expected his office managers to gather and transmit financial information to Hill, who would then prepare his tax returns. Rick would simply sign his tax returns, apparently without reading them. However, his first office manager, Ms. Dobbs, did not handle his tax matters properly and was fired. She was replaced by Ms. Simeone, who also did not handle Rick's tax matters appropriately. Rick alleged that Simeone embezzled from him and destroyed or altered his financial records.

The Lyerlys did not promptly file their 2005-2007 returns. They filed those returns late and paid the resulting taxes still later. IRS then applied some of the tax payments to the wrong tax years and made numerous errors in assessing the tax for those tax years. Years later, but before the expiration of the statute of limitations under §6501(a), IRS sent letters to the Lyerlys that they owed no penalties or interest for 2005-2007. After the expiration of the statute, IRS assessed penalties for late filing; IRS offset the penalties against an overpayment that the Lyerlys had made.

The Lyerlys sued in district court for a refund of the penalties and for compensatory and punitive damages for the numerous errors that IRS made. IRS brought a motion for summary judgment on the issue of the penalties.

The court rejected the Lyerlys' request for compensatory and punitive damages for IRS's errors.

The court said that while the Eleventh Circuit-the circuit to which an appeal in this case would go-has not yet published a decision interpreting §7433, the Fifth Circuit has.

Observation: As observed by the court, all decisions of the former Fifth Circuit handed down before close of business on September 30, 1981 are binding on the Eleventh Circuit. *(Bonner v. City of Prichard, Ala.*, (CA11 1981) 661 F.2d 1206)

The Fifth Circuit said that §7433 does not provide a remedy for improper assessment of taxes. (*Gandy Nursery, Inc.,* (CA5 2005) 95 AFTR 2d 2005-2783) That Court explained the difference between proving a case for improper "collection" as compared to improper "assessment" of taxes. It clarified that, in order to show "improper assessment, a taxpayer must demonstrate why no taxes are owed," while "to prove a claim for improper collection practices, the taxpayer must demonstrate that IRS did not follow the prescribed methods of acquiring assets." (*Shaw,* (CA5 1994) 73 AFTR 2d 94-1998)

The Lyerlys argued that IRS failed to follow assessment procedures. There was no claim that IRS disregarded proper collection procedures. Instead, the allegations were that the Lyerlys did not owe the penalties. Thus, the court said, the Lyerlys' only possible remedy in this action was a refund of overpaid taxes and/or penalties.

The court, citing Lewis, rejected the Lyerlys' claim that, because the penalties were barred by the statute of limitations, they were owed a refund on the tax penalties.

The court noted that Lewis does not involve the assessment of penalties, which was the issue before the court in this case. The court, however, looked to two cases that applied Lewis to facts that involved penalties for filing a late tax return. In one of those cases, *Loftin & Woodard, Inc.,* (CA 5 1978) 42 AFTR 2d 78-5637, a corporation was assessed a penalty for a late filing of its 1961 tax return. When, in 1962, the corporation filed for a refund of some of the 1961 taxes based on carryback of losses suffered in 1962, IRS audited the 1961 return and disallowed several of the deductions that the corporation had claimed. The disallowance of these deductions increased the corporation's taxable income for 1961, and therefore, when the late filing penalty was applied to the amount of taxable income, the amount owed for that year increased. IRS then used the newly calculated amount for 1961 as a set off against the refund due from the 1962 losses.

In Loftin, the corporation brought suit, claiming that the higher penalty amounted to "additional" taxes, which were barred by the statute of limitations. However, the court held that the "assessment, as a set-off against a refund, does not represent the imposition of an additional or new tax" because "the delinquency penalty already was in existence prior to the 1962 return as a result of the 1961 return being filed late."

Like in Loftin, the Lyerlys filed their tax return late. Therefore, the reasoning in Loftin, which states that the penalty already was in existence as a result of the return being filed late, was applicable. The date of the assessment of the penalties was irrelevant, because they were already collected and could be retained by IRS whether or not their assessment was barred by the statute of limitations.

The court also rejected the Lyerly's claim that IRS should be estopped from claiming penalties because IRS said in early communications with the Lyerlys that there were no penalties.

The court said that it can only provide the remedy of a refund of overpayment as authorized under 28 USC 1346(a)(1) and that Lewis makes it clear that a taxpayer is only entitled to a refund if the taxpayer has overpaid his taxes. The Lyerlys bore the burden of showing that there was an overpayment, and, the court said, the early communications about which they argued were not relevant in making that determination. The Lyerlys' estoppel allegation did not show that they did not owe these taxes.

IRS's motion for summary judgment on the assessment of the late filing penalties was rejected by the court. IRS asserted that these penalties are mandatory. Conversely, the Lyerlys alleged that, because their failure to file was due to reasonable cause and not due to willful neglect, the penalties should not have been assessed.

Reasonable cause for failure to file exists if "the taxpayer 'exercised ordinary business care and prudence,' but nevertheless was unable to file the return on time." (*In re Sanford,* (CA 11 1992) 71 AFTR 2d 93-405 (quoting Regulation §301.6651-1(c)(1)) alternatively, a "court may find reasonable cause...if a taxpayer convincingly demonstrates that a disability beyond his control rendered him unable to exercise ordinary business care." (Sanford)

The Lyerlys claimed that they had reasonable cause for not filing their tax returns because Rick had a multitude of health and emotional problems, their office manager had been embezzling from them, and they had relied on their accountant to timely file their returns. According to the Lyerlys, Rick's health problems required him to rely on his accountant and office manager to take care of financial matters such as filing tax returns.

The court then cited several rules set down by the Supreme Court in *Boyle,* (S Ct 1985) 55 AFTR 2d 85-1535. A serious illness of the taxpayer or his immediate family is considered reasonable cause by IRS. However, "the failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not reasonable cause for a late filing." Yet, in situations where "a taxpayer relied on an attorney or accountant because the taxpayer, was, for some reason, incapable...of meeting the criteria of ordinary business care and prudence...the disability alone could well be an acceptable excuse for a late filing."

The court said that Rick's reliance on his accountant and office manager to file the returns did not constitute reasonable cause for his failure to file, but a question of fact remained about whether his illness was serious enough to excuse Rick's late filing.

Further, IRS considers "destruction by casualty of the taxpayer's records or place of business" to be reasonable cause, and "casualty" is defined by IRS as "an identifiable event that is sudden unexpected, or unusual," such as vandalism. (*Boyle*; IRS Publication 547) Here, Simeone indisputably destroyed some of Rick's records. However, it remained a question of fact if this was enough to be "destruction by casualty" and constitute reasonable cause for his failure to file.

Makric Enterprises, Incorporated v. Commissioner, (CA 5 3/27/2017) 119 AFTR 2d ¶ 2017-580.

The Court of Appeals for the Fifth Circuit, affirming the Tax Court, has concluded that there was no mutual mistake affecting the form of the sale of a company's stock which would require a reformation of the transaction. The Court also found that IRS properly rejected a good faith or reasonable cause exception and imposed an accuracy-related penalty under §6662.

Under Danielson rule, a taxpayer generally cannot use the substance-over-form doctrine to challenge the tax consequences of his own agreement unless the agreement was unenforceable on account of mistake, fraud, duress, or undue influence. (*Commissioner v. Danielson*, (CA 3 1967) 19 AFTR 2d 1356)

Under §6664(c)(1), an accuracy-related penalty under §6662 or a fraud penalty under §6663 will generally not apply to any portion of an underpayment if it is shown that there was reasonable cause for that portion and that the taxpayer acted in good faith. This defense can potentially be established by, among other things, reliance on the advice of a tax professional. (*U.S. v. Boyle,* (S Ct 1985) 55 AFTR 2d 85-1535)

A taxpayer claiming reliance on a tax professional must prove that: (1) the adviser was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer provided necessary and accurate information to the adviser; and (3) the taxpayer actually relied in good faith on the adviser's judgment. (*Neonatology Associates,* (2000) 115 TC 43, aff'd (CA 3 2002) 90 AFTR 2d 2002-5442)

Mark Kisner, Rickey Williams, and Jim Wilson owned 100% of the stock of Makric Enterprises Incorporated (Makric), a holding company, which in turn solely owned 100% of the stock of Alpha Circuits, Inc. (Alpha), an operating company. The Makric shareholders sought to sell Alpha to TS3 Technology, Inc. (TS3).

Originally, the sale was designed as a two-step process: (1) Makric would be dissolved; and (2) the Makric shareholders would sell the Alpha stock directly to TS3. The initial drafts of the stock purchase agreement reflected such an arrangement, but the Makric shareholders were advised this would not have the desired tax consequences.

The Makric shareholders determined that their preferred structure would be a sale of their Makric stock to TS3. However, subsequent stock purchase agreement drafts created an arrangement under which TS3 would purchase the Alpha stock directly from Makric, leaving the Makric shareholders holding their Makric stock. The executed version of the stock purchase agreement and multiple ancillary documents confirmed this mechanism.

The Makric shareholders contend that, although one of them read these drafts where Makric was selling its shares of Alpha, they believed they were actually selling their shares in Makric.

The Makric shareholders and Makric filed tax returns erroneously reflecting a sale of Makric stock to TS3. On audit, IRS issued a notice of deficiency to Makric. Makric sought relief in the Tax Court.

The Tax Court found that Makric was required to report in income gain on the sale of its subsidiary Alpha's stock. The Court held that Makric's argument that the transaction was, in substance, a sale by its shareholders of their Makric stock, rather than the subsidiary's stock, was barred by the Danielson rule because the agreement effecting the transaction was unambiguous and clearly required the sale of the subsidiary's stock. Even if the Danielson rule did not apply, the Court concluded that the overall evidence belied Makric's position and showed that the sale was in both form and substance a sale of the subsidiary's stock. *(Makric Enterprises, Inc.,* TC Memo 2016-44)

The Tax Court also rejected Makric's argument that the parties to the agreement made a mutual mistake such that reformation was required, finding that Makric failed to show that there was any mistake as to which entity was the seller and whose stock was being sold. Although Makric's shareholders may have intended to sell Makric's rather than Alpha's stock, and although the purchaser may have been amenable to such, those facts were irrelevant and did not change the terms or substance of the agreement they actually reached.

Makric offered two pieces of evidence to show that the sale of Alpha was the result of mutual mistake: (1) its CEO's email instructing the TS3 lawyer to structure the transaction so that TS3 would purchase Makric, not Alpha; and (2) its president's testimony that he reached an agreement with a TS3 representative that Makric's shareholders would sell Makric to TS3. However, the Tax Court was unable to conclude that the two pieces of evidence showed that the stock purchase agreement was the result of a mutual mistake.

While the email showed that the CEO intended, at one time, to structure the transaction as the sale of Makric, that email was sent seven months before the parties executed the stock purchase agreement; over the course of those seven months, there were several drafts of the stock purchase agreement created and reviewed, as well as a number of other documents, all of which contradicted the premise that the parties intended to exchange Makric stock, rather than Alpha stock. And while the Court considered Makric president's testimony credible and found it plausible that each side's negotiators, at some point, approved the structure described in the email, the weight of the evidence-including the transactional documents (i.e., the stock purchase agreement and the consent forms executed at the closing of the sale)-indicated that Makric and TS3 had agreed to a different structure by the time they executed the stock purchase agreement.

The Court also determined that Makric failed to establish a reasonable cause or good faith exception to the imposition of an accuracy-related penalty. Although it used a return preparer for the subject year's return and although the preparer failed to report sale gain on the basis of the erroneous assumption that the sale was of Makric's rather than Alpha's stock, the preparer was told that the assumption was correct by Makric's CFO. However, the CFO had not read the sale agreement himself, consulted counsel, or otherwise taken reasonable steps to verify the correctness of that assumption. The fact that the CFO may in turn have relied on erroneous advice from an investment banker or possibly the CEO was not an excuse.

Makric appealed, alleging the Tax Court erred in (1) determining that there was no mutual mistake affecting the form of the sale, and (2) rejecting Makric's argument that it qualified for the good faith or reasonable cause exception to the accuracy-related penalty.

The Fifth Circuit affirmed the Tax Court, finding that the interested party's testimony and one ambiguous email supporting the taxpayer's position were insufficient to establish clear error on the part of the Tax Court in its conclusion that there was a sale of Makric's stock. Makric only pointed to a general stated desire for the transaction to have favorable tax consequences and a single email from Makric's CEO, which stated that, "The purchase will be Makric which owns 100% of Alpha's shares." On the other hand, the Tax Court and IRS relied on twelve versions of the purchase agreement, supporting documentation, and the affidavit of TS3's chairman.

The Court rejected Makric's contention that the Tax Court should have authorized a reformation of the transaction to remedy the parties' mutual mistake in structuring the sale. The Court reasoned that there were two basic requirements which had to be met before the remedy of reformation was granted: (1) the party claiming the relief must show what the parties' true agreement was; and (2) that party must show that the instrument incorrectly reflected that agreement because of a mutual mistake. Reformation is unavailable unless the party claiming a mistake presents clear, exact, and satisfactory evidence, that it is entitled to it. The Fifth Circuit found that Makric failed to do so.

Turning to the accuracy-related penalty and good faith or reasonable cause exception, the Fifth Circuit found that Makric again failed to show clear error. The Tax Court determined that Makric's president had reviewed the documents and still walked away with an incorrect view of the contract. But, the Fifth Circuit noted that a review of the documents by itself was not enough to automatically establish reasonable cause in light of all of the facts and circumstances. The form of the transaction was not complicated, Makric's president was advised by counsel and an investment banking group, and he could have even given his CPA a copy of the executed agreement, but instead both Makric's president and CFO incorrectly instructed the CPA as to the form of the transaction. The Fifth Circuit stated that it was important that taxpayers take reasonable precautions to ensure that they determine their tax liability properly, and for a $16.5 million purchase, Makric failed to show that the Tax Court clearly erred in determining that Makric did not take such precautions.

May v. U.S., (CA 9 5/16/2017) 119 AFTR 2d ¶ 2017-752.

The majority of the Court of Appeals for the Ninth Circuit, reversing and remanding a district court, has concluded that a taxpayer who neither filed a Form 8886 (Reportable Transaction Disclosure Statement) nor sent it to the Office of Tax Shelter Analysis (OTSA), failed to do what was necessary to start the running of the statute of limitations for the penalty for failing to disclose a listed transaction. Accordingly, the one-year limitations period under §6501(c)(10)(A) did not begin, and IRS's assessment of the penalty was timely.

"Any person who fails to include on any return or statement any information with respect to a reportable transaction which is required under §6011 to be included with such return or statement shall pay a penalty." (§6707A(a)) A reportable transaction is a transaction which IRS determines as having a potential for tax avoidance or evasion. (§6707A(c)(1)) Any reportable transaction that "is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of §6011 " is a "listed transaction." (§6707A(c)(2))

Ordinarily, IRS may only assess a tax within three years after the return was filed. (§6501(a)) But a separate statute of limitations, found in §6501(c)(10), governs listed transactions. It provides that, if a taxpayer fails to include on any return or statement for any tax year any information with respect to a listed transaction which is required under §6011 to be included with such return or statement, the time for assessment of any tax with respect to such transaction will not expire before the date which is one year after the earlier of: (a) "the date on which the Secretary is furnished the information so required," or (b) the date that a material advisor meets the material advisor requirements of §6112.

Regulation §1.6011-4(a) provides that the "disclosure requirements of this section" mandate that a taxpayer "must file within the time prescribed in paragraph (e) of this section a disclosure statement in the form prescribed by paragraph (d) of this section." Regulation §1.6011-4(d) provides that a taxpayer required to file a disclosure statement for any listed transaction must attach Form 8886 to the return filed with IRS. The regulation further provides that, "If the form is not completed in accordance with the provisions in this paragraph (d) and the instructions to the form, the taxpayer will not be considered to have complied with the disclosure requirements of this section." In addition, Regulation §1.6011-4(e) requires taxpayers to send a copy of the Form 8886 to OTSA "at the same time that any disclosure statement is first filed."

Stephen May filed his 2004 return in 2005. He engaged in a listed transaction (the Challenged Transaction) in 2004, which he did not report on Form 8886.

IRS acknowledged that, by March 2010, it had sufficient information from which to determine that May had engaged in the Challenged Transaction. The parties' briefings did not explain clearly how all the required information came into IRS's possession. The court said that it appeared that several individuals and organizations, over the course of several years, furnished that information to different IRS agents.

It was not until February 6, 2012, however, that IRS assessed May a penalty under §6707A for failing to disclose his participation in the Challenged Transaction.

The district court held that IRS's imposition of the listed transaction penalty was time-barred under §6501(c)(10)(A) because the assessment occurred more than one year after May's IRS examining agent came into possession of enough information to justify the penalty. The court found that there was no support in the Code for IRS's contention that only the filing of Form 8886 triggers the statute of limitations under §6501(c)(10)(A). The court reasoned that the §6011 requirement to use certain forms when filing returns could not change the fact that, under §6501(c)(10)(A), it is the furnishing of information, and not the submission of a particular form, that triggers the limitations period. Further, the court found it was irrelevant whether all of the required information was furnished by May himself; under §6501(c)(10)(A) the statute of limitations begins to run on the date when the required information "is furnished" to IRS. (*May,* (DC AZ 6/15/2015) 115 AFTR 2d 2015-2155)

The majority Ninth Circuit opinion concluded that the district court was in error when it determined that IRS's imposition of the listed transaction penalty was time-barred because the assessment occurred more than one year after May's IRS examining agent came into possession of enough information to justify the penalty.

The Court reasoned that while §6501(c)(10)(A) is unclear when read in isolation because it does not define or explain the terms "the information so required," it is clear when read in the context of the rest of §6501(c)(10) and in conjunction with §6011 (to which it expressly refers). What must be filed to begin the running of the limitations period is as indicated in the introductory paragraph to §6501(c)(10) -that "which is required under §6011 to be included with [a] return or statement." §6011 instructs that taxpayers "shall make a return or statement according to the forms and regulations prescribed by the Secretary" and that "[e]very person required to make a return or statement shall include therein the information required by such forms or regulations." Thus, in §6501(c)(10) and §6011(a), Congress expressly required taxpayer compliance with IRS's determination of how listed transactions are to be reported.

IRS exercised its authority to determine how taxpayers will report listed transactions by implementing Regulation §1.6011-4(d), which provides that "[a] taxpayer required to file a disclosure statement under this section must file a completed Form 8886, 'Reportable Transaction Disclosure Statement'..., in accordance with...the instructions to the form" and that "[t]he Form 8886...is the disclosure statement required under this section." Thus, Regulation §1.6011-4(d) clarifies (a) that the passive phrase "is furnished" means that the taxpayer must provide the information and (b) that a completed Form 8886 is "the information so required."

In sum, the Court concluded that §6501(c)(10)(A) 's reference to "the information so required" under §6011 functions as an incorporation by reference of the disclosure requirements of Regulation §1.6011-4(d), which requires that a taxpayer disclosing a listed transaction do so on Form 8886 and send a completed copy of that disclosure to the OTSA. It is undisputed that May neither filed a Form 8886 nor sent it to the OTSA. Accordingly, he failed to do what was required to start the running of the §6501(c)(10)(A) statute of limitations. Thus, the one-year limitations period under §6501(c)(10)(A) did not start, and IRS's assessment of the penalty was timely.

Circuit Judge Clifton disagreed with the majority opinion, finding that it exalted form over substance. While §6501(c)(10)(A) says that the limitations period starts running on "the date on which the Secretary is furnished the information so required," IRS on the other hand contended that it did not actually matter when the relevant information was provided to the appropriate IRS agents because the provision of information does not count unless it is presented to IRS on Form 8886. The dissent concluded that this was not a logical reading of the statute.

Although it would have been simple to write a statute that stated that the limitations period started to run on the date when the taxpayer provides the information to the Secretary on the form specified by the Secretary, that's not how Congress wrote the statute. Similarly, it would have been simple for the Secretary to have promulgated a regulation that clearly informed all taxpayers that providing information to IRS does not count unless the information is provided on the specified form. Instead, in presenting its position, IRS had to trace its way through §6011 and Regulation §1.6011-4 to support its interpretation. The dissent found that the fact that so much effort was needed to support a simple albeit illogical interpretation-that providing the information did not count if it was not on the specified form-suggested that the interpretation was not one that should be adopted.

Maze v. IRS, (CA DC 7/14/2017) 120 AFTR 2d ¶ 2017-5054.

The Court of Appeals for the District of Columbia Circuit, affirming a district court, has concluded that the Anti-Injunction Act, barred the suit of the taxpayers who did not meet the requirements of IRS's 2014 Streamlined Filing Compliance Procedures (a voluntary program for persons who had not properly complied with foreign account reporting requirements) and who nonetheless sought to have the court allow them to participate in that program.

The Code strictly limits the circumstances under which a suit to enjoin the assessment or collection of any tax is permitted. Under §7421(a) (also known as the Anti-Injunction Act), no suit for the purpose of restraining the assessment or collection of any tax can be maintained in any court by any person, whether or not that person is the one against whom the tax is assessed, except as otherwise provided. While the Anti-Injunction Act does not bar all legal claims pertaining to taxation, it does bar those suits seeking to restrain the assessment or collection of taxes.

Taxpayers have, however, a number of other ways to challenge the assessment and collection of taxes, including, for example, paying and suing for a refund under §7422.

The Anti-Injunction Act does not apply at all where the plaintiff has no other remedy for its alleged injury. The Act was intended to apply only when Congress has provided an alternative avenue for an aggrieved party to litigate its claims. (*Z Street,* (CA Dist Col 2015) 115 AFTR 2d 2015-2190)

Since 2009, IRS has had programs in place to encourage compliance by persons that are not in compliance with reporting requirements with respect to foreign assets, accounts and income.

Two of those programs are the Offshore Voluntary Disclosure Programs ("OVDPs") and Streamlined Filing Compliance Procedures ("SFCP" or "Streamlined Procedures").

To participate in the 2012 OVDP, a taxpayer must comply with the following requirements, among others: (a) file eight years of tax returns and Reports of Foreign Bank and Financial Accounts (FBARs); (b) pay tax and interest for eight years; and (c) pay accuracy-related penalties for eight years.

In return for full compliance with the applicable requirements, IRS offers participants the following three primary benefits: (1) with the exception of the accuracy-related penalties under §6662(a), IRS will compromise all penalties in return for the taxpayer paying 27.5% of the aggregate value of the taxpayer's foreign assets (the compromise penalty is sometimes referred to as the miscellaneous Title 26 offshore penalty); (2) IRS will not recommend to the Department of Justice criminal prosecution for any matter relating to tax noncompliance or failure to file FBARs; and (3) IRS and the taxpayer sign a closing agreement which constitutes a final settlement of all matters relating to the disclosure period and to years prior to the disclosure period. Altogether, these actions bar IRS from taking action based on any tax delinquency in the years before the 8-year disclosure period. (https://www.irs.gov/individuals/international-taxpayers/offshore-voluntary-disclosure-program-frequently-asked-questions-and-answers-2012-revised)

In 2014, IRS introduced the SFCP. To participate in the SFCP, a taxpayer is required to comply with the following requirements, among others: (a) file three years of tax returns and six years of FBARs; (b) pay tax and interest for three years; and (c) pay a miscellaneous Title 26 offshore penalty equivalent to 5% of the value of the taxpayer's foreign assets. The SFCP are intended for U.S. taxpayers whose failure to disclose their offshore assets was non-willful.

In return, these filings and payments serve as a compromise for all penalties not involving willfulness for the three years covered by the program. However, IRS can pursue the taxpayer for fraud-related penalties for all years and for willful FBAR penalties for all years, as well as other penalties from the years prior to the three years subject to this program. The Streamlined Procedures do not involve any assurance regarding a decision not to refer the matter for criminal prosecution-as the OVDP does-nor do they involve a final settlement agreement resolving tax issues pertaining to prior years. (https://www.irs.gov/individuals/international-taxpayers/u-s-taxpayers-residing-in-the-united-states)

Under the "Transition Rules" or "Transition Treatment," a taxpayer that had already entered an OVDP before July 1, 2014 may be able to receive the favorable penalty terms of the Streamlined Procedures, but must remain in the OVDP in order to do so. He is liable for only the 5%, not the 27.5%, miscellaneous Title 26 offshore penalty. The benefit of non-prosecution letters remains available under the Transition Treatment because the participants never exit the OVDP itself; instead, they remain bound by the rules of that program. IRS has discretion in allowing taxpayers Transition Treatment based on its assessment of the willfulness involved in the taxpayer's past reporting failures. ("Transition FAQs"; https://www.irs.gov/individuals/international-taxpayers/transition-rules-frequently-asked-questions-faqs)

After a number of years of failing to report funds held in foreign bank accounts, the taxpayers each entered IRS's 2012 OVDP. Beginning in 2014, however, they tried to withdraw from the 2012 OVDP and apply for the Streamlined Procedures. Each taxpayer was told that doing so was not possible. IRS told them that they could not enter the 2014 SFCP through any route other than the Transition Rules.

The taxpayers did not claim that they paid all of the taxes and penalties they owed with respect to all eight tax years relevant to the voluntary programs considered in this case; they claimed that they paid taxes for the three years covered by the Streamlined Procedures.

The taxpayers claimed that IRS's actions harmed them, and they sued to have the court allow them to directly enter the 2014 SFCP. The taxpayers also sought to retain benefits that are available only under the OVDP-specifically, assurances from IRS that it would not refer matters for criminal prosecution for past tax years.

The district court ruled that under §7421(a) it did not have jurisdiction to hear the taxpayers' suit. Because the taxpayers' action sought to restrain the assessment or collection of taxes and the taxpayers had alternative remedies, it held that the Anti-Injunction Act stripped it of jurisdiction to hear the taxpayers' case. (*Maze,* (DC Dist Col 7/27/2016) 118 AFTR 2d 2016-5226)

The DC Circuit determined that §7421(a) barred the taxpayers' suit.

The Court reasoned that the taxpayers, as participants in the 2012 OVDP, were required to pay eight years' worth of accuracy-based penalties. These penalties were treated as taxes under §7421(a), and any lawsuit that sought to restrain their assessment or collection was therefore barred. This lawsuit, in which the taxpayers sought to qualify to enroll in the Streamlined Procedures, did just that because the Streamlined Procedures do not require a participant to pay any accuracy-based penalties for the three years covered by the program. Accordingly, the taxpayers' lawsuit, if successful, would have the effect of restraining-fully stopping-IRS from collecting accuracy-based penalties for which they are currently liable. The DC Circuit concluded that this fact alone demonstrated that §7421(a) barred their suit.

The Court rejected the taxpayers' contention that their claim did not fall within the Anti-Injunction Act's scope because they sought only the ability to apply for the Streamlined Procedures (a route currently foreclosed by the Transition Rules), not court-ordered enrollment. They argued that their eligibility to enroll alone had no immediate tax consequence. However, the Court noted that it had never applied the Anti-Injunction Act without considering the practical impact of its decision. Rather, the Court has recognized the need to engage in a careful inquiry into the remedy sought and any implication that the remedy may have on assessment and collection. Here, the taxpayers conceded that they would enroll in the Streamlined Procedures if they were deemed eligible, thereby stopping IRS from collecting the 2012 OVDP accuracy-based penalties.

The Court also rejected the taxpayers' argument that their eligibility for, or enrollment in, the Streamlined Procedures would not necessarily prevent IRS from collecting the accuracy-based penalties because they would be liable for all taxes and penalties if IRS determined that they either acted willfully in failing to report their overseas assets or failed to comply with the requirements of the Streamlined Procedures program. But the Court found that the fact that the taxpayers' attempt to take advantage of the Streamlined Procedures' more lenient tax treatment might be thwarted by the possibility of an adverse IRS determination did not make their lawsuit one that was not brought for the purpose of restraining the assessment or collection of any tax.

The DC Circuit acknowledged that the Anti-Injunction Act does not apply where the taxpayer has no other remedy for its alleged injury. The Anti-Injunction Act was intended to apply only when Congress has provided an alternative avenue for an aggrieved party to litigate its claims. Here, the DC Circuit determined that this requirement was met. As the district court noted, the taxpayers can pay their taxes and file a refund suit. Their ability to initiate a refund suit-an adequate "alternative avenue"-means that the Anti-Injunction Act applies to them.

The Court rejected that taxpayers' objection that, in a refund suit, they could challenge only the amount of their tax liability, not the Transition Rules themselves. Disagreeing with that contention, the Court noted that IRS had acknowledged at oral argument that the taxpayers may indeed challenge the Transition Rules in a refund action.

McClendon v. U.S., (DC TX 3/6/2017) 119 AFTR 2d ¶ 2017-506.

Denying a motion for reconsideration, a district court has upheld its decision that the owner of a business who lent his business $100,000 to pay its next payroll, after learning that an employee embezzled millions of withheld taxes, was liable for the full $4.3 million responsible person penalty under §6672 for unpaid employment taxes.

§6672 imposes a responsible person penalty (which is also known as the trust fund recovery penalty or the 100% penalty) on any person who: (1) is responsible for collecting, accounting for, and paying over payroll taxes; and (2) willfully fails to perform this responsibility. The amount of the penalty is equal to the amount of the tax that was not collected and paid.

In *Barnett*, (CA 5 1993) 71 AFTR 2d 93-1614, the Fifth Circuit concluded that, "Willfulness under §6672 requires only a voluntary, conscious, and intentional act, not a bad motive or evil intent." In that case, the Court ruled that a responsible person acted willfully where he knew of the corporation's unpaid liabilities and failed to apply certain amounts towards them; the Court rejected the taxpayer's unsupported claim that the amounts were "pledged" to the bank and held that they were unencumbered as a matter of law for §6672 purposes. Accordingly, Court found that the taxpayer "willfully" failed to pay the $492,101 in available, unencumbered funds deposited into company bank accounts after he became aware that the accrued withholding taxes were due. However, the Court in Barnett disagreed with IRS that another $425,000 in uncollected accounts receivable due from one of the company's customers could be considered as a liquid asset that could have been used by the responsible person to pay the balance of the accrued taxes, finding that amount was simply not yet available to use to pay the accrued taxes.

Dr. McClendon was the owner of Family Practice, a medical services provider. In 1995, Family Practice hired Richard Stephen as its Chief Financial Officer. By 2009, Family Practice owed over $10 million in unpaid payroll and other withholding taxes. Dr. McClendon learned that these taxes were unpaid on May 11, 2009. Stephen plead guilty to three counts of felony theft of money that he embezzled from Family Practice.

Family Practice stopped operating and remitted its remaining receivables to IRS to pay toward the tax liability. Dr. McClendon made a $100,000 personal loan to Family Practice "for the restricted purpose of...using the funds to pay the May 15, 2009 payroll." Family Practice used that loan to pay its employees.

IRS assessed a $4.3 million responsible person penalty on Dr. McClendon.

The court, rejecting Dr. McClendon's arguments and granting IRS's summary judgment, held that he was liable for the $4.3 million assessed penalty. (*McClendon v. U.S.,* (DC TX 11/17/2016) 118 AFTR 2d 2016-6549)

Dr. McClendon conceded that he was a responsible person within the statute. The only issue was whether he willfully failed to collect, account for, or pay taxes that Family Practice owed to IRS. The court said that a responsible person has a duty to ensure that a taxpayer's unencumbered funds are used to pay back taxes it owes IRS, rather than to pay other creditors. A considered decision not to fulfill one's obligation to pay the taxes owed, evidenced by payments made to other creditors in the knowledge that the taxes are due, is all that is required. Payment of wages to employees counts as a payment to a creditor for purposes of this principle. (*Logal,* (CA 5 1999) 84 AFTR 2d 99-7047)

The district court rejected Dr. McClendon's argument that because he loaned the money to Family Practice on the understanding that it could use the money only to cover payroll, the funds were "encumbered" and that willfulness is shown as a matter of law only by evidence that a responsible person directed "unencumbered" funds to a creditor other than the government. The court noted that the Barnett Court incorporated the Eighth Circuit's analysis of "encumbrances," citing *Honey* (CA 8 1992) 69 AFTR 2d 92-1333, for the proposition that funds are encumbered "only where the taxpayer is legally obligated to use the funds for a purpose other than satisfying the preexisting employment tax liability and if that legal obligation is superior to the interest of IRS in the funds." Voluntarily assumed contract obligations to use certain funds for a specific purpose are not the sort of "legal obligation...superior to the interest of IRS" that Honey contemplated. The court said that the funds lent by Dr. McClendon were not "encumbered" for purposes of determining whether the trust fund recovery penalty applied.

Observation: This case demonstrates that even a small payment to someone other than IRS can cause a huge penalty. The penalty is generally 100% of the unpaid amount, and the act of paying someone else, rather than the amount paid to that party, is what generates that penalty.

The court rejected Dr. McClendon's argument for reconsideration that his liability be limited to the $100,000 preferential payment, rather than the $4.3 million assessed. The court cited two reasons: (1) the taxpayer could and should have raised the argument in the summary judgment briefing, but did not do so; and (2) the taxpayer had the burden of proof of coming forward with evidence as to the absence of sufficient unencumbered funds available to his medical practice to cover the practice's tax liability, but did not do so.

Dr. McClendon did not raise his current argument before asking the district court to reconsider its grant of IRS's summary judgment motion. Instead, in his opposition to the summary judgment motion, he relied on the argument that he did not act willfully. His brief for summary judgment did not contain any arguments at all on whether he owed the full penalty amount regardless of the court's willfulness finding. The district court held that because the taxpayer failed to raise this argument in his response to IRS's motion for summary judgment, he cannot raise it for the first time in his motion for reconsideration.

Further, in a tax-refund case in which IRS puts a penalty assessment in evidence, the taxpayer has the burden to prove that he was not a responsible person or did not willfully fail to pay the taxes owed. The court noted that, for purposes of the earlier motion for summary judgment as well as for purposes of the current motion for reconsideration, Dr. McClendon did not show what funds were available to Family Practice or show that whatever funds existed were encumbered so that he had no obligation to pay them to IRS. Instead, he argued that, at summary judgment, it was IRS's burden to demonstrate his liability for each dollar of the penalty. The court pointed out that, in fact, this was not the case. Dr. McClendon was presumptively liable for the balance of the IRS penalty assessed against him.

The district court reasoned that IRS moved for summary judgment and argued that the evidence did not create a genuine factual dispute material to deciding whether the IRS penalty was properly assessed. That discharged IRS's summary judgment burden. Dr. McClendon (who would also bear such a burden at trial) then had the burden to submit or identify record evidence showing that he was not liable. It was not IRS's job to prove that Dr. McClendon had sufficient funds to cover the tax obligation but chose not to pay. Just the opposite. It was Dr. McClendon's job to disprove the presumption that he was liable for the penalty by accounting for Family Practice's funds and demonstrating that they could not cover the tax obligation.

The district court also found that Dr. McClendon's citation to Barnett was inapposite. In that case, the taxpayer seeking a refund had proved at trial what funds were available to the company and demonstrated that there was not enough money to cover part of the tax obligation. Here, Dr. McClendon had not met his burden. And so, he was not entitled to reversal or modification of the court's judgment against him.

McClendon, (DC TX 11/17/2016) 118 AFTR 2d ¶ 2016-5464.

A district court has held that where an employee embezzled $10 million of withheld payroll taxes and other withholding taxes, and the owner of the business, after learning of the embezzlement, lent the business $100,000 for the specific purpose of paying its next payroll, the owner was liable for the responsible person penalty because he used the funds for purposes other than paying payroll taxes.

§6672 imposes the responsible person penalty (also known as the 100% penalty) on any person who: (1) is responsible for collecting, accounting for, and paying over payroll taxes; and (2) willfully fails to perform this responsibility. The amount of the penalty is equal to the amount of the tax that was not collected and paid.

Dr. McClendon was the owner of Family Practice, a medical services provider. In 1995, Family Practice hired Richard Stephen as its Chief Financial Officer. By 2009, Family Practice owed over $10 million in unpaid payroll and other withholding taxes. Dr. McClendon learned that these taxes were unpaid on May 11, 2009. Stephen pleaded guilty to three counts of felony theft of money that he embezzled from Family Practice.

Family Practice stopped operating and remitted its remaining receivables to IRS to pay toward the tax liability. Dr. McClendon made a $100,000 personal loan to Family Practice "for the restricted purpose of...using the funds to pay the May 15, 2009 payroll." Family Practice used that loan to pay its employees.

IRS assessed a $4.3 million responsible person penalty on Dr. McClendon.

The court rejected Dr. McClendon's arguments and held that he was liable for the assessed penalty.

Dr. McClendon conceded that he was a responsible person within the statute. The only issue was whether he willfully failed to collect, account for, or pay taxes that Family Practice owed to IRS.

The court said that a responsible person has a duty to ensure that a taxpayer's unencumbered funds are used to pay back taxes it owes IRS, rather than to pay other creditors. Citing Barnett, (CA 5 1993) 71 AFTR 2d 93-1614, it said "Willfulness under §6672 requires only a voluntary, conscious, and intentional act, not a bad motive or evil intent...A considered decision not to fulfill one's obligation to pay the taxes owed, evidenced by payments made to other creditors in the knowledge that the taxes are due, is all that is required." Payment of wages to employees counts as a payment to a creditor for purposes of this principle. (L*ogal,* (CA 5 1999) 84 AFTR 2d 99-7047) "If a responsible person knows that withholding taxes are delinquent, and uses corporate funds to pay other expenses, even to meet the payroll out of personal funds he lends the corporation," he has acted willfully within the meaning of the statute. (Ph*illips,* (CA 9 1996) 77 AFTR 2d 96-379)

Dr. McClendon first argued that because he loaned the money to Family Practice on the understanding that it could use the money only to cover payroll, the funds were "encumbered" and that willfulness is shown as a matter of law only by evidence that a responsible person directed "unencumbered" funds to a creditor other than the government.

Dr. McClendon argued that because he loaned the money to Family Practice with the express restriction that it could use the money only to cover payroll, the funds were "encumbered." He argued that this "restriction" from the lender was an "encumbrance" legally sufficient to shield him from liability for Family Practice's use of the money to pay the employees' wages and salaries, rather than to pay the government.

But the court here said that the Barnett Court incorporated the Eighth Circuit's analysis of "encumbrances," citing *Honey* (CA 8 1992) 69 AFTR 2d 92-1333, for the proposition that funds are encumbered "only where the taxpayer is legally obligated to use the funds for a purpose other than satisfying the preexisting employment tax liability and if that legal obligation is superior to the interest of IRS in the funds." The court here said that the Sixth Circuit explained, in following and in applying Honey that Honey does not stand for the proposition that a responsible person can shield himself from liability by entering into preferential lending arrangements, in which the person voluntarily assumes a contractual obligation to pay some set of creditors before paying the government. (*Bell,* (CA 6 2004) 93 AFTR 2d 2004-369) Voluntarily assumed contract obligations to use certain funds for a specific purpose are not the sort of "legal obligation...superior to the interest of IRS" that Honey contemplated.

The court said that the funds lent by Dr. McClendon were not "encumbered" in the relevant sense and so concluded that Dr. McClendon's argument failed.

Dr. McClendon also argued that he had reasonable cause because "he acted morally and generously in using his own money to make sure Family's staff...were paid for the work they had performed."

The court noted that the Fifth Circuit, i.e., the circuit to which this case would be appealable, has consistently recognized that it is possible for a responsible person to evade a willfulness finding by demonstrating "reasonable cause" to pay a creditor and not IRS. However, the court said, in the Fifth Circuit, no taxpayer appears to have successfully demonstrated reasonable cause.

The court said that the fact that Dr. McClendon's motives were admirable was not legally relevant. Dr. McClendon provided no authority for holding that a taxpayer who consciously decides to use unencumbered funds to pay a creditor other than the government had reasonable cause to do so because the taxpayer had good motives. The Fifth Circuit has made clear that a taxpayer who consciously decides to use unencumbered funds to pay a creditor other than the government cannot benefit from the reasonable cause defense. There was no basis for a different result here.

Observation: This case demonstrates that even a small payment to someone other than IRS can cause a huge penalty. The penalty is always 100% of the unpaid amount, and the act of paying someone else, rather than the amount paid to that party, is what generates that penalty.

McCree, TC Memo 2017-145.

The Tax Court has ruled on a number of procedural issues including that the fact that IRS sent IRS Letter 4464C, Questionable Refund 3rd Party Notification, to the taxpayer questioning withholding on her return, did not constitute an audit of that return.

§7605(b) provides that "only one inspection of a taxpayer's books of account shall be made for each tax year unless...the Secretary... notifies the taxpayer in writing that an additional inspection is necessary."

IRS has taken the position that limited contacts between IRS and taxpayers, such as verifying discrepancies or "matching information on a tax return with... other records or information items that are already in the Service's possession" do not constitute "examinations." (Revenue Procedure 2005-32, 2005-1 CB 1206, §4.03)

§6320(a)(1) and §6330(a)(1) require IRS to give a taxpayer written notice when a Federal tax lien is filed upon the taxpayer's property or IRS intends to levy upon the taxpayer's property. The notice must inform the taxpayer of the right to request a collection due process (CDP) hearing in the Appeals Office (Appeals). If a taxpayer makes a timely written request and states the grounds for the requested hearing, the taxpayer is entitled to a fair hearing conducted by an impartial officer from Appeals. (§6320(a)(3)(B), §6330(a)(3)(B)) However, a taxpayer is precluded from contesting the existence or amount of the underlying tax liability at such a hearing unless the taxpayer did not receive a deficiency notice or otherwise have an opportunity to dispute the liability. (§6330(c)(2)(B))

After the administrative hearing is completed, Appeals issues a written notice of determination indicating whether the notice of Federal tax lien should remain in effect and/or the proposed levy may proceed. (§6330(c)(3); Regulation §301.6320-1(e)(3) Q&A E8; Regulation §301.6330-1(e)(3) Q&A E8)

A taxpayer may appeal an Appeals determination to the Tax Court within 30 days of the determination, and if an appeal is timely filed, the Court will have jurisdiction with respect to the matter. (§6330(d)(1), Regulation §301.6330-1(f)(1)) Courts consider a taxpayer's challenge to her underlying liability in a collection action case only if she properly raised that challenge at her CDP hearing. (Regulation §301.6330-1(f)(2), Q&A F-3)

Ms. McCree filed her 2010 income tax return on which she requested a refund. Months later, IRS's Integrity & Verification Operation (IVO) issued a Letter 4464C, Questionable Refund 3rd Party notification, to McCree. The letter informed McCree that her 2010 refund was being held pending the IVO's review and verification of withholding shown on that return. Letter 4464C stated that McCree was "not required to do anything at this time." A month after receiving that letter, McCree received the refund that she applied for.

A year later, IRS issued a statutory notice of deficiency with respect to McCree's 2010 return. McCree did not timely petition the Court in response to the notice of deficiency. IRS then assessed the deficiency and sent McCree a notice of balance due. In response, McCree submitted to IRS an Offer in Compromise (OIC) (Doubt as to Liability). McCree challenged the correctness of the tax liability by submitting documentation regarding a deduction that she had not taken on the original return.

While the Appeals Officer (AO) was considering McCree's OIC, IRS issued to McCree a notice of intent to levy. McCree then requested a CDP hearing; with her request, she sent the same documentation that she sent along with her OIC.

The CDP hearing Settlement Officer (SO), in his letter to McCree to schedule the CDP hearing, erroneously informed McCree that she would be unable to dispute the underlying liability at the CDP hearing.

SO informed McCree that, on the basis of the documents she provided to support her OIC, AO abated part of her income tax liability. SO again erroneously informed McCree that she would be unable to contest the 2010 tax liability. McCree then stated that she did not owe the tax and wanted to review AO's determination.

SO and McCree then had a CDP hearing phone call, but McCree said she wanted her day in court, and SO then stopped the CDP hearing. McCree petitioned the Tax Court. IRS then filed a motion for a remand and stated that the purpose would be to allow McCree an opportunity to raise arguments about her 2010 underlying liability. The Court granted IRS's motion.

McCree and IRS then scheduled a supplemental CDP hearing. At that hearing, McCree did not offer any additional documents or information challenging the underlying liability; she instead asserted that IRS misallocated funds by issuing her a refund. The newly assigned AO, AO Lam, then issued to McCree a letter scheduling a follow-up supplemental CDP hearing and gave McCree several alternatives with respect to resolving the various issues. McCree did not respond to this letter or to subsequent phone calls. The new IRS SO then issued a supplemental notice of determination in which he sustained the proposed levy.

The issues were whether: (1) McCree challenged the existence or amount of her 2010 income tax liability in her CDP hearing; (2) the petition raised valid claims for relief; (3) IRS had broken the "one audit" rule; and (4) IRS was precluded from determining a deficiency after issuing a refund.

The Court concluded that McCree did effectively challenge the existence of her tax liability at her CDP hearing.

The Court said that an issue is not properly raised at the CDP hearing if the taxpayer fails to request consideration of that issue by Appeals or if she requests consideration but fails to present any evidence after being given a reasonable opportunity to do so.

Before the initial CDP hearing, McCree attached to her OIC documents that supported reducing her underlying liability. During the review of McCree's OIC, AO abated some of the tax liability on the basis of the documentation she provided. McCree attached those same documents to her CDP hearing request and contested her underlying liability during her initial CDP hearing. Even though SO erroneously thought she could not consider McCree's underlying liability and did not allow McCree to contest it, McCree properly raised the issue and provided evidence that resulted in a reduction of her underlying liability.

In the supplemental CDP hearing, AO Lam gave McCree an opportunity to contest the remainder of her underlying liability, but McCree declined the opportunity.

The Court concluded that McCree's failure to substantively participate in the supplemental CDP hearing did not negate her earlier proper challenge to her underlying liability. It said that it is well settled that a taxpayer is entitled to a single hearing under §6330 with respect to the period to which the unpaid liability relates. Therefore, the Court said, citing *Kelby,* (2008) 130 TC 79, that when the Court remands a case to Appeals, the further hearing is a supplement to the taxpayer's original §6330 hearing, not a new hearing.

The Court then rejected IRS's argument that McCree did not challenge her underlying liability in this case. It found that, viewing the statements in the petition and attached documents and the inferences drawn from those statements and documents liberally, McCree challenged her underlying liability in the petition.

The Court then rejected McCree's argument that IRS audited her twice.

McCree argued that Letter 4464C is evidence of an audit or, in other words, an inspection of her "books of account" for 2010.

However, the Court said that to inspect the books of account would require, at a minimum, that IRS have access to and physically view a taxpayer's books and records and that §7605(b) is not to be read so broadly as to defeat the powers granted to IRS to examine the correctness of a taxpayer's return.

Here, the Letter 4464C did not request that McCree produce her "books of account" or other records. Indeed, Letter 4464C stated that McCree was "not required to do anything at this time," and she was issued her claimed refund without a request for documents or information. The IVO's senior technical advisor stated that Letter 4464C was issued to McCree because her tax return was identified for possible inflated withholdings. The IVO then determined that McCree had reported her withholdings correctly, but it did not evaluate or determine whether she had reported her income correctly.

The Court said that research of records in IRS possession to verify withholdings does not constitute an examination.

McCree argued that IRS was negligent in issuing her a refund and therefore should not be allowed to assert a deficiency against her. But the Court concluded that the practice of issuing refunds before examining a return does not estop IRS from later determining a deficiency on the return at issue and seeking to recover the funds previously allowed as a refund.

McNeill, (2017) 148 TC No. 23.

Tax Court has jurisdiction to hear a partner's challenge, at the partner level, of IRS's actions to collect from the partner, via lien and levy, an accuracy-related penalty imposed on the partnership with respect to partnership items.

§6320(a)(1) and §6330(a)(1) require IRS to give a taxpayer written notice when a Federal tax lien is filed upon the taxpayer's property or IRS intends to levy upon the taxpayer's property. The notice must inform the taxpayer of the right to request a collection due process (CDP) hearing in the Appeals Office. If a taxpayer makes a timely written request and states the grounds for the requested hearing, the taxpayer is entitled to a fair hearing conducted by an impartial officer from the Appeals Office. (§6320(a)(3)(B), §6330(a)(3)(B)) However, a taxpayer is precluded from contesting the existence or amount of the underlying tax liability at such a hearing unless the taxpayer did not receive a deficiency notice or otherwise have an opportunity to dispute the liability. (§6330(c)(2)(B))

After the administrative hearing is completed, the Appeals Office issues a written notice of determination indicating whether the notice of Federal tax lien should remain in effect and/or the proposed levy may proceed. (§6330(c)(3); Regulation §301.6320-1(e)(3) Q&A E8; Regulation §301.6330-1(e)(3) Q&A E8)

A taxpayer may appeal the Appeals Office determination to the Tax Court within 30 days of the determination, and if an appeal is timely filed, the Court will have jurisdiction with respect to the matter. (§6330(d)(1), Regulation §301.6330-1(f)(1))

Under the TEFRA partnership audit rules, "the tax treatment of any partnership item (and the applicability of any penalty...which relates to an adjustment to a partnership item) shall be determined at the partnership level." (§6221) Likewise, §6230(a)(2)(A)(i) excludes from deficiency procedures "penalties that relate to adjustments to partnership items." Regulation §301.6221-1(c) provides that "[p]artner-level defenses to such items can only be asserted through refund actions following assessment and payment," and Regulation §301.6221-1(d) provides that "[p]artner-level defenses to any penalty...may be asserted through separate refund actions following assessment and payment."

The taxpayers were Mr. and Mrs. McNeill. Mr. McNeill was a partner in LABAITE, a partnership. IRS issued to LABAITE's partners a notice of final partnership administrative adjustment (FPAA) for 2003, reflecting an $11.5 million adjustment to LABAITE's partnership items and imposing an accuracy-related penalty under §6662.

In June 2008, IRS sent McNeill a notice and demand for payment for his unpaid balance. In April 2009, IRS sent him a notice of intent to levy and a Notice of Federal Tax Lien Filing. Shortly thereafter, the McNeills timely submitted a request for a CDP hearing. On this request, the McNeills disputed their liability for the §6662 penalty.

IRS mistakenly determined that the McNeills had a prior opportunity to dispute their liability and so determined that the collection action for 2003 should proceed and that the assessment of the unpaid penalty was valid.

The McNeills timely filed their petition with the Tax Court. The only issue before the Court at this time was whether it had jurisdiction to hear the McNeills' case.

The Court held that, notwithstanding the relevant TEFRA rules, it had jurisdiction to hear the case.

Here, the §6662 accuracy-related penalty asserted against the McNeills was based on a partnership-level adjustment to partnership items LABAITE reported. Therefore, under §6221 and §6230, deficiency procedures were inapplicable.

The Court noted that it has, on multiple occasions, addressed the expansion of its jurisdiction to include review of collection determinations regardless of the type of underlying liability. (See, for example, Yari, (2014) 143 TC 157.) In each such case, the Court concluded that, although it lacked original jurisdiction over the underlying liability, it nonetheless had exclusive jurisdiction to review appeals from IRS's lien and levy determinations.

Here, the McNeills' underlying liability-a penalty that related to an adjustment to a partnership item-was not subject to the Court's deficiency jurisdiction. (See §6230(a)(2)(A)(i), Regulation §301.6221-1(c) and Regulation §301.6221-1(d).) But the removal of such penalties from the Court's jurisdiction was overridden in the context of CDP review. IRS determined that the McNeills could not raise the issue of their underlying liability in their CDP hearing; IRS sent the McNeills a notice of determination; and the McNeills timely filed a petition with the Court.

The Court reasoned that Congress created the CDP process to provide taxpayers who are confronted with a lien filing or a proposed levy the opportunity to contest that collection action before IRS proceeds to collect the outstanding tax liability. The current version of §6330 is a result of an expansion of Tax Court's jurisdiction in 2006, which made the Tax Court the exclusive venue for review of CDP cases. The Court said that the intent of that expansion was not to preclude from review certain issues not subject to the Tax Court's deficiency jurisdiction. The McNeills' §6662 accuracy-related penalty was another example of an item not subject to the Court's deficiency jurisdiction under §6221 but nonetheless reviewable by the Court in the context of its §6330 jurisdiction.

Meidinger v. Commissioner, (CA 11 10/24/2016) 118 AFTR 2d ¶2016-5345.

The Court of Appeals for the Eleventh Circuit, affirming a district court, has rejected a whistleblower's petition for injunctive relief to compel IRS's Whistleblower Office to re-open claims that the Office had dismissed as being duplicative of those that he had submitted earlier. The Eleventh Circuit found that whistleblower claims are reviewed by the Tax Court and that the district court lacked the authority to grant the requested relief.

Under §7623, IRS has discretionary authority to pay awards to informants (whistleblowers) in the sums it considers necessary for the detection of tax underpayments, or for the detection, trial, and punishment of tax law violators, payable from the proceeds of the "amounts collected" by reason of the information provided. §7623(b) provides that if IRS proceeds with any administrative or judicial action based on the information provided by a whistleblower, that individual shall receive an award equal to 15-30% of the collected proceeds resulting from the action (including related actions) or from any settlement in response thereto. So, a whistleblower's entitlement to an award turns on: (i) whether there was a collection of proceeds, and (ii) whether that collection was in some way attributable to the information provided by the whistleblower.

A whistleblower may appeal IRS's award determination to the Tax Court within 30 days of such determination. (§7623(b)(4)) A whistleblower may then appeal the Tax Court's decision to the applicable Court of Appeals. (§7482(a))

In 2009, Roy Meidinger filed a Form 211, Application for Award for Original Information, with IRS's Whistleblower Office, in which he provided information about the alleged improper tax practices of an organization.

In a letter dated June 11, 2012, Meidinger was informed by the Whistleblower Office that the information he provided did not result in the collection of any proceeds and that he therefore was not eligible for an award under §7623. He appealed the decision to the Tax Court on June 29, 2012.

On August 30, 2013, the Tax Court determined on summary judgment that Meidinger was not entitled to a whistleblower award based on its finding that IRS did not proceed with an administrative or judicial action based on the information he provided and thus did not collect any proceeds.

Meidinger appealed the Tax Court's decision to the Court of Appeals for the Eleventh Circuit two weeks later. He then filed additional Form 211s with the Whistleblower Office. The Office dismissed these claims as "re-submissions" of previously submitted information. The Eleventh Circuit affirmed the Tax Court on May 13, 2014.

Meidinger subsequently brought a district court case seeking injunctive relief-specifically, an order compelling IRS to conduct an investigation based on the information that he provided and re-open his claims. The district court denied the relief requested and dismissed the case for lack of jurisdiction, stating that if he wanted to contest the Whistleblower Office's dismissals of his subsequent submissions, he must first exhaust administrative remedies then appeal to the Tax Court, as required under §7623(b). (*Meidinger v. Commissioner*, (DC FL 07/01/2015) 116 AFTR 2d 2015-5026) The district court then denied Meidinger's motion for reconsideration of its decision, finding that he did not show any change in law, error, or other grounds warranting same. (*Meidinger v. Commissioner,* (DC FL 09/21/2015) 116 AFTR 2d 2015-6218) Meidinger appealed.

The Court of Appeals for the Eleventh Circuit affirmed the district court, finding no abuse of discretion.

First, the Appellate Court found that the district court properly determined that it lacked authority to grant the requested injunctive relief. §7623(b)(4) clearly provides that appeals from a denied Form 211 application are to be filed with the Tax Court. The district court had no jurisdiction to review either the Whistleblower Office's determination or the Tax Court's determination. Further, Meidinger did appeal the denial of his Form 211 application, and this denial was upheld both by the Tax Court and the Court of Appeals.

The Appellate Court also found no abuse of discretion in the district court's denial of Meidinger's motion for reconsideration, noting that it was similar to his initial position and reflected an attempt to "relitigate old matters."

Mescalero Apache Tribe, (2017) 148 TC No. 11.

The Tax Court has rejected IRS's argument that §6103 's confidentiality rule prohibited it from providing an employer that it was auditing with the amounts of federal income tax that were paid by employees that the employer had misclassified as independent contractors. The employer was attempting to apply §3402(d) 's rule that allowed it to offset its liability for withheld tax by the income tax paid by those workers.

§3402(a) requires every employer to deduct and withhold a tax on the wages it pays. The employer itself is liable for this withholding tax. (§3403) But the tax is really in aid of the tax owed by the employee on the income he earns. The employee gets a credit on his income tax bill for the money withheld by his employer from his paycheck.

§3402(d) lets an employer who fails to deduct and withhold the tax on wages escape tax liability if it can show the workers paid income tax on their earnings.

§6103(a) provides a general rule that returns and return information should be kept confidential. The term "return information" includes the amount of a taxpayer's tax payments. (§6103(b)(2)(A))

There are a number of exceptions to §6103(a) 's general rule. One of those exceptions, §6103(h)(4), provides: "A return or return information may be disclosed in a Federal or State judicial or administrative proceeding pertaining to tax administration, but only...(B) if the treatment of an item reflected on such return is directly related to the resolution of an issue in the proceeding; [or] (C) if such return or return information directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer which directly affects the resolution of an issue in the proceeding."

As part of an audit, IRS reclassified many of the independent contractors of the taxpayer, the Mescalero Apache Tribe (the Tribe), as employees.

The Tribe sought to avail itself of the relief provided by §3402(d) by determining whether the reclassified independent contractors paid the income tax on the income that the Tribe paid them. One way to do this would be for the Tribe to ask each worker to complete Form 4669, Statement of Payments Received. (Internal Revenue Manual pt. 4.23.8.4) The Tribe tried to do that, but it was only partly successful because many of the Tribe's former workers had moved and some lived in hard-to-reach areas.

The Tribe brought suit against IRS to discover the records of 70 workers to determine whether they reported their Form 1099 income and paid their tax liabilities and then to have IRS adjust the Tribe's liability accordingly.

IRS objected, claiming that the discovery was barred under §6103 and that it amounted to a prohibited shift of the burden of proof from the Tribe to IRS.

The Court concluded that §6103(h)(4) permitted the disclosure requested by the Tribe.

It first noted that the circuits are split on the question of whom information can be disclosed to under §6103(h)(4). The Fifth Circuit focused on the title of the §6103(h)(4), "Disclosure to Certain Federal

Officers and Employees For Purposes of Tax Administration, Etc." and read §6103(h) to allow release of third-party return information only to officials of the Department of the Treasury or the Department of Justice. (*Chamberlain* (CA 5 1979) 43 AFTR 2d 79-657)

The Tenth Circuit, however, specifically rejected that argument in *First Western Gov't §, Inc.,* (CA 10 1986) 58 AFTR 2d 86-5401. It reasoned that, while §6103(h)(1), §6103(h)(2) and §6103(h)(3) speak of disclosure to officials, §6103(h)(4) speaks specifically of disclosure in a judicial or administrative tax proceeding with no indication that disclosure should be limited to officials. The court found disclosure proper in judicial and administrative tax proceedings in general. And, the Court here noted, most courts below the Circuit Court level have followed the Tenth Circuit and not the Fifth Circuit's approach.

While there was some question in the Tax Court's mind as to in which circuit an appeal in this case would be heard, the Court assumed that it would be the Tenth Circuit and followed the Tenth Circuit's rule.

The Court then turned its attention to exactly what information can be disclosed under §6103(h). Looking at §6103(h)(4)(B), it noted that that subparagraph only refers to "returns" and not "return information." It noted that the Fifth and Sixth Circuits have decided that it does not provide for disclosure of return information. But the Tenth Circuit, in one case where it specifically discussed the return vs. return information issue and in another where it did not specifically have that discussion, concluded that §6103(h)(4)(B) did provide for disclosure of return information. The Court then concluded that it did not need to decide that issue.

It instead looked to §6103(h)(4)(C), which covers both returns and return information, and analyzed it in pieces. First it asked, "what is a transaction relationship?" It said that to "transact" means simply "to carry on business." Citing a large number of cases that looked at that question, the Court said that the wide variety of business relationships that other courts have held are transactional relationships led it to hold that the relationship between an employer and his worker is one that pertains to the carrying on of business.

Second, the Court asked whether the return information that the Tribe was asking for "directly relate[d]" to this relationship. It concluded that whether the Tribe's workers paid their tax liabilities in full tended to show whether they considered themselves independent contractors or employees and thus directly related to their relationship with the Tribe.

Finally, as to the issue of whether the return information affected the resolution of an issue in the proceeding, the Court said that it did, stating "If the Tribe's workers did indeed pay their tax liabilities, then the Tribe's §3402(d) defense would be proved and would be entirely resolved."

Court also rejects IRS's burden of proof argument. The Court also rejected IRS's argument that the Tribe's request amounted to a shifting of the burden of proof.

It said that the question of who bears the burden of proof on an issue has no effect on the obligation to comply with appropriate discovery requests that it is up to the party opposing the production to show that the information is not discoverable, and that IRS did not make that showing.

Observation: This holding will have wide-reaching effect because obtaining signed Form 4669 from a worker is often difficult for a business because: a) of the fact that IRS audits often take place years after the relevant payroll tax return is filed, combined with the fact that, particularly in certain labor-intensive industries, a business' workers may turn over frequently and may be difficult to reach; and b) those workers that the business does reach, particularly those that no longer work for the business, may not wish to sign Form 4669. Thus, this holding will often make the difference between the business being forced to pay the withholding tax, even where the worker already paid the corresponding income tax, and the business not having to make that payment.

Milton v. U.S. (DC WA 6/14/2017) 119 AFTR 2d ¶ 2017-863.

On a reconsideration of its previous decision, a district court concluded that §6511(b)(2)(A) was jurisdictional. Accordingly, where the taxpayer failed to show that his financial disability under §6511(h) tolled the limitations period, the court lacked subject matter jurisdiction over the claims.

In general, a taxpayer must file a claim for credit or refund of tax within three years after filing the return or two years after paying the tax, whichever period expires later. (§6511(a))

If a claim for refund or credit is filed within the above-described 3-year period, then the credit or refund amount cannot exceed the part of the tax paid within the period, immediately preceding the filing of the claim, equal to three years plus the period of any extension of time for filing the return. (§6511(b)(2)(A)) If the claim was not filed within the 3-year period, the amount of the credit or refund cannot exceed the portion of the tax paid during the two years immediately preceding the filing of the claim. (§6511(b)(2)(B))

The periods of limitation under §6511(a) and §6511(b) are suspended for any period of an individual taxpayer's life during which he or she is financially disabled. (§6511(h)(1))

An individual is financially disabled if he or she is unable to manage his financial affairs because of a medically determinable mental or physical impairment that can be expected to result in death, or has lasted (or can be expected to last) for a continuous period of not less than 12 months. But an individual is not considered to have a financially disabling impairment unless proof of the existence thereof is furnished in such form and manner as IRS may require. (§6511(h)(2)(A))

IRS sets out the requirements for claiming a financial disability under §6511(h) in Revenue Procedure 99-21, 1999-17 IRB 18. They include a written statement from the taxpayer and a written statement from a physician (as defined in §1861(r)(1) of the Social Security Act, 42 USC §1395x(r)) who is qualified to make a determination as to the taxpayer's impairment. Thus, to qualify as a physician for this purpose, one must be a doctor of medicine or osteopathy, a doctor of dental surgery or dental medicine, a doctor of podiatric medicine, a doctor of optometry, or a licensed chiropractor. IRS requires that the physician's statement containing specified information be submitted with a refund claim in order to claim financial disability. (Revenue Procedure 99-21)

Andrew Milton failed to file his 2000 income tax return. His wife assumed power of attorney in 2014 and filed a late tax return claiming a refund for $585,559.

Milton alleged that he "suffered from a financial disability that made him unable to deal with financial or business matters" from 2000 to 2013. He claimed that he therefore fell within §6511(h) 's tolling provision that suspends the time bar in §6511 for individuals who are financially disabled. He submitted a statement as to his financial disability from Tim Liddle, an MA, LMHC, MAC-respectively, Master of Arts, Licensed Mental Health Counselor, Master Addiction Counselor.

IRS denied the refund, stating it was outside the statute of limitations. Milton sued IRS for this refund in district court.

In court, IRS argued that Milton filed his late return and refund claim in violation of §6511(b)(2)(A), and so the court lacked subject matter jurisdiction over the claims. The court found that it had jurisdiction over the matter because Milton met his burden under §6511(a), concluding that §6511(b)(2)(A) was not a jurisdictional obstacle. IRS moved for the court to reconsider this decision.

The district court determined that manifest error would result in not reconsidering its prior ruling.

On reconsideration, the district court found that §6511(b)(2)(A) was jurisdictional. The court looked to *C.I.R. v. Lundy,* (S Ct 1996) 77 AFTR 2d 96-406, where the Supreme Court found that §6511 "contains two separate provisions for determining the timeliness of a refund claim"-the filing deadline and the "look-back" period-that are jurisdictional prerequisites to bringing suit. The court also looked to *Reynoso v. U.S.,* (CA 9 2012) 110 AFTR 2d 2012-5748, and *Zeier v. U.S.,* (CA 9 1996) 77 AFTR 2d 96-1653, where the Ninth Circuit held that §6511(b)(2)(A) was jurisdictional.

The Court concluded that §6511(b)(2)(A) 's look-back period only allows taxpayers to claim refunds for taxes paid within the three years immediately preceding the filing of the claim. Thus, §6511(b)(2)(A) provides that a claim for credit for an overpayment of tax may not be asserted for an overpayment which was paid more than three years (plus any allowed extension time) prior to the claim. By filing his return in 2014, Milton could only seek refunds for overpayment of taxes he paid from 2011-2014. Accordingly, Milton's claim was outside the statutory period.

The district court also determined that Milton failed to satisfy his burden to show a financial disability under §6511(h) and that the court therefore lacked subject matter jurisdiction over his claim for a refund. The court found that none of the designations (MA, LMHC, MAC) of the person signing Milton's physician's note qualified him as a physician as defined by §1395x(r). The court concluded that this was a fatal error in demonstrating a financial disability that would toll the limitation period and not merely a technical deficiency. Congress deliberately drafted the definition of "physician" narrowly, and the district court would not disturb that decision.

Gary Minda et al. v. U.S., (CA 2 3/24/2017) 119 AFTR 2d ¶ 2017-571.

The Court of Appeals for the Second Circuit, affirming the district court, concluded that a taxpayer was entitled to statutory damages from IRS only for IRS's single act of disclosing a report of proposed changes in his return and not separately for the disclosure of each item of information contained in that report.

Under §6103(a), no officer or employee of the U.S. is permitted to disclose any return or return information, except to the extent disclosure is authorized under the Code. (§6103(a)(1))

If an officer or employee of the U.S. "knowingly, or by reason of negligence," discloses a return or return information of a taxpayer, subject to certain exceptions that were not applicable here, the taxpayer may bring a civil action for damages against the U.S. in district court. (§7431(a)(1))
Under §7431(c), in any such action, the one who discloses (the defendant) is liable to the taxpayer (plaintiff) in an amount equal to the sum of:

1. The greater of:

    a. $1,000 for each act of unauthorized inspection or disclosure of a return or return information with respect to which such defendant is found liable, or

b. The sum of: (i) the actual damages sustained by the taxpayer as a result of the unauthorized inspection or disclosure, plus (ii) in the case of a willful inspection or disclosure or an inspection or disclosure which is the result of gross negligence, punitive damages; plus

2. The costs of the action; plus

3. In the case of a taxpayer who follows statutorily prescribed procedures in applying for an award of fees and meets net worth requirements for prevailing party status under §7430, reasonable attorneys fees, except that if the one who discloses is the U.S., reasonable attorneys fees may be awarded only if the taxpayer is the prevailing party (as determined under §7430(c)(4)).

In *AMW Materials Testing, Inc. v. Town of Babylon,* (CA 2 2009) 584 F.3d 436, the Second Circuit determined that gross negligence requires conduct that is "highly unreasonable and which represents an extreme departure from the standards of ordinary care...to the extent that the danger was either known to the defendant or so obvious the defendant must have been aware of it," that is, "conduct that evinces a reckless disregard for the rights of others or smacks of intentional wrongdoing." In *Barrett v. U.S.,* (CA 5 1996) 78 AFTR 2d 96-7375, the Fifth Circuit, affirming the dismissal of a punitive damages claim under §7431(c), noted that conduct that is grossly negligent is marked by "wanton or reckless disregard of the rights of another." The Second Circuit determined in *Curley v. AMR Corporation ,* (CA 2 1998) 153 F.3d 5, that to be grossly negligent, "the act or omission must be of an aggravated character, as distinguished from the failure to exercise ordinary care."

IRS conducted an examination of the 2007 income tax return of Gary Minda and Nancy Findlay Frost (the taxpayers). IRS prepared an 11-page report proposing changes to the return, but instead of sending the report to the taxpayers, IRS sent nine pages of the report, which included their names, Social Security numbers, and detailed financial information, to an unauthorized, unrelated third party. The taxpayers did not suffer any actual damages as a result of the unauthorized disclosure of their return information.

After investigating, the Treasury Inspector General for Tax Administration determined: that the report, which was dated October 5, 2009, was printed the week of September 28, 2009 for review by a financial technician; the report was "likely co-mingled" with a report for another taxpayer dated September 28, 2009; the two reports were generated by different units located in different departments working different shifts and using different printers; and that the IRS employee who made the unauthorized disclosure could not be identified. An IRS employee speculated that the report had been accidentally left on a printer and then gotten mixed in with the other taxpayer's documents. Another IRS employee hypothesized that a "network error" might have caused the report to print on the wrong printer.

In the district court, IRS conceded that it had negligently disclosed the taxpayers' return information to a third party. While IRS requested that the district court deny all relief other than statutory damages, the taxpayers, who admitted that they did not suffer any actual damages, argued that they were entitled to statutory damages for each item of information disclosed in the report and that punitive damages were appropriate.

The district court granted IRS summary judgment, finding that the taxpayers were entitled to only to $1,000 each in statutory damages for IRS's admittedly unauthorized disclosure of their return information, via its agent's mailing of examination report to a third party. The statutory damages under §7431 applied to each disclosure act, such as the act of mailing, and not to each separate piece of return information contained within that mailing, as the taxpayers argued.

The court found that there was no proof of willful conduct or gross negligence on IRS's part that warranted punitive damages. The district court concluded that the fact that IRS could not explain how the disclosure occurred and that examination report contained documents from different printers located in different departments did not in themselves establish anything more than ordinary negligence. (*Minda v. U.S.,* (DC NY) 116 AFTR 2d 2015-6407) Gary Minda appealed the decision.

The Second Circuit, agreeing with the district court, concluded that the language of §7431(c)(1)(A) was unambiguous, and that the statute clearly provides an aggrieved taxpayer $1,000 in statutory damages for "each act" of unauthorized disclosure, not for each item of information disclosed.

The Court rejected the taxpayer's argument that §7431(c) should be read to impose a penalty for each item of return information disclosed, finding that such a position ignored the plain words of the statute and would require the Court to read words into the statute that were not there.
The Court reasoned that §7431(c)(1)(A) provides that an aggrieved taxpayer is entitled to statutory damages of $1,000 for "each act" of unauthorized inspection or disclosure. The word "act" is not defined in the statute and so is presumed to have its ordinary meaning. The ordinary meaning of the word "act"- the thing done or being done-is in this case the act of unauthorized inspection or disclosure, i.e., a single act of disclosure, the errant mailing of the report.

The Court noted that §7431(c)(1)(A) refers to "each act of...disclosure of a return or return information." A return will of course contain multiple items of information, and likewise "return information" clearly encompasses multiple items of information. Yet, §7431(c)(1)(A) treats the disclosure of either -"a return or return information"-as one act subject to one award of statutory damages of $1,000.

Finally, the Second Circuit found that the taxpayer's interpretation did not make sense. The report arguably contained dozens of items of return information, as there were more than a hundred different entries. Under the taxpayer's theory, each of these items would constitute a separate disclosure, and he would be entitled to more than $100,000 in statutory damages, even though he suffered no actual damages and IRS was guilty of only one act of unauthorized disclosure.

The Second Circuit also determined that the district court correctly granted summary judgment to IRS denying the taxpayers' claim for punitive damages. The taxpayer pointed to no evidence of aggravated conduct or the wanton or reckless disregard of his rights or conduct smacking of intentional wrongdoing. While, to be sure, someone at IRS failed to exercise reasonable care, sending nine pages of the report to the wrong person, nothing in the record suggested that this was anything other than the result of simple negligence or carelessness. On the record presented to the district court, a reasonable fact finder could conclude only that the report inadvertently became commingled with another taxpayer's documents, and that an IRS employee then sent the package to that taxpayer without realizing it contained materials relating to another taxpayer.

David Myers, (2017) 148 TC No. 20.

While rejecting IRS's argument that only the first of five letters sent to a whistleblower over almost a 12-month period reflected a "determination" from which the taxpayer could within 30 days appeal IRS's denial of an award under §7623(b)(4), the Tax Court has nonetheless determined that the whistleblower received actual notice of IRS's determinations without prejudicial delay and had ample opportunity to timely file a petition, but failed to do so. Accordingly, the Tax Court lacked jurisdiction.

Under §7623, IRS has discretionary authority to pay awards to informants (whistleblowers) in the sums it considers necessary for the detection of tax underpayments, or for the detection, trial, and punishment of tax law violators, payable from the proceeds of the "amounts collected" by reason of the information provided. §7623(b) provides that if IRS proceeds with any administrative or judicial action based on the information provided by a whistleblower, that individual shall receive an award equal to 15-30% of the collected proceeds resulting from the action (including related actions) or from any settlement in response thereto.

A whistleblower may appeal IRS's award determination to the Tax Court within 30 days of such determination. (§7623(b)(4)) A whistleblower may then appeal the Tax Court's decision to the applicable Court of Appeals. (§7482(a))

David Myers filed a claim for a whistleblower award under §7623(b) with IRS's Whistleblower Office. The Whistleblower Office denied Myers' claim, stating in a letter dated March 13, 2013, that he was not eligible for an award and inviting him to contact them with any further questions.

Myers continued to correspond with the Whistleblower Office during 2013 and 2014, sometimes submitting additional material regarding his claim. In response, the Whistleblower Office sent him four separate letters. By letters dated November 20, 2013, January 8, 2014, and March 6, 2014, the Whistleblower Office stated that it had "considered the additional information you provided and determined your claim still does not meet our criteria for an award." By letter dated February 24, 2014, the Whistleblower Office informed Myers that his claim had been closed on March 13, 2013, and attached a copy of the March 13, 2013, letter.

On January 20, 2015, Myers mailed his petition to the Tax Court, which received and filed it on January 26, 2015. At the hearing before the Court, Myers testified that he was confused by the Whistleblower Office's letters and his options for redress, spending "months" pursuing what he referred to as an "administrative claims process," and was not aware of his ability to appeal to the Tax Court until shortly before he did so. IRS moved to dismiss the case for lack of jurisdiction on the ground that Myers had failed to file his petition within the 30-day period specified under §7623(b)(4).

The Tax Court determined that Myers received actual notice of the Whistleblower Office's determinations without prejudicial delay and had ample opportunity to timely file a petition, yet Myers filed his petition significantly more than 30 days after receiving actual notice. Accordingly, his petition was untimely, and the Tax Court dismissed the case for lack of jurisdiction.

The Court found that he received and thus had actual notice of all of the Whistleblower Office's letters by no later than April 11, 2014. Yet despite having ample opportunity to timely file a petition, he did not do so until January 26, 2015-290 days after April 11, 2014.

As with a notice of deficiency, the Court held that if there was direct evidence that a claimant received actual notice of an award determination without prejudicial delay and with sufficient time to file a petition, that notice was effective to begin the running of the 30-day period under §7623(b)(4). While IRS admitted that the Whistleblower Office did not send any of the five letters to the taxpayer by certified mail, and the Court found that the evidence that IRS submitted to attempt to prove the date and fact of mailing was, standing alone, insufficient, the Court concluded that there was direct evidence in the record before it that Myers received actual notice of these letters without prejudicial delay and with sufficient time to file a petition. In his filings and in a hearing before the Court, Myers admitted without reservation that he received each letter. Although he could not recall exactly when he received each letter, it was clear that he did so shortly after their dates.

Rejecting IRS's argument that only the March 13, 2013, letter reflected a "determination" from which the taxpayer could appeal to the Tax Court under §7623(b)(4), the Tax Court also concluded that each of the Whistleblower Office's letters to Myers constituted a determination for purposes of §7623(b)(4). The Court found that IRS's argument ignored the Tax Court's clear observation i*n Comparini,* (2014) 143 TC 274, that as to a single whistleblower claim, the Whistleblower Office may issue multiple determinations, on any of which the Court's jurisdiction pursuant to §7623(b)(4) may be based.

The Whistleblower Office sent five letters to Myers over nearly 12 months in 2013 and 2014 regarding his claim. The Court noted that it had held that there were no particular formal requirements for what constitutes a determination by the Whistleblower Office for purposes of §7623(b)(4). (*Cooper,* (2010) 135 TC 70) A written notice informing a claimant that IRS has considered information that he submitted and has decided whether the information qualifies the claimant for an award generally will be sufficient. (Comparini) Because of this broad standard and the back-and-forth nature of many whistleblower claims-as claimants submit additional information either spontaneously or at the Whistleblower Office's behest-the Whistleblower Office could conceivably issue several determinations appealable to the Tax Court over the course of adjudicating a whistleblower claim. A claimant need not parse the determinations for indications that the 30-day period to appeal to the Tax Court has begun.

Nelly Home Care, Inc., (DC PA 4/19/2017) 119 AFTR 2d ¶ 2017-665.

A district court has held that, for purposes of the rule that a taxpayer cannot be awarded litigation costs if IRS's position is substantially justified, the fact that a taxpayer wins a case against IRS on summary judgment is not dispositive of whether IRS had substantial justification for its position. And, the court found IRS's position was substantially justified, despite its loss on summary judgment, because there had been no precedent involving the issue that was decided on summary judgment.

A prevailing party may recover reasonable administrative costs and litigation costs incurred in a tax matter brought by or against IRS. (§7430(a)) The prevailing party is the party which has "substantially prevailed with respect to the amount in controversy or has substantially prevailed with respect to the most significant issue or set of issues presented." (§7430(c)(4)(A)) A party is not treated as the prevailing party if IRS establishes that its position was substantially justified. (§7430(c)(4)(B)(i))

IRS bears the burden of showing that its position was substantially justified. (*Center for Family Medicine* (CA 8 2010) 106 AFTR 2d 2010-5494)

An employer is liable for back employment taxes when it incorrectly treats an employee as not being an employee. (§3509(a))

But Section 530 of the Revenue Act of 1978 (Section 530), as amended, provides that a taxpayer that incorrectly treats an employee as an independent contractor is nevertheless exempt from employment tax liability if it meets three requirements:

a. The taxpayer does not treat any other individual holding a substantially similar position as an employee for purposes of employment taxes for any period;

b. The taxpayer has consistently treated the worker as not being an employee for post-1978 periods, including by filing all required federal tax returns on a basis consistent with this treatment; and

c. The taxpayer has a reasonable basis for not treating the individual as an employee.

A taxpayer can show that it had a "reasonable basis" to not treat an individual as an employee if the taxpayer based this classification on reasonable reliance upon:

1. Judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer;

2. A past IRS audit of the taxpayer in which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position held by this individual; or

3. Long-standing recognized practice of a significant segment of the industry in which such individual was engaged. (Section 530)

Moreover, a taxpayer who can demonstrate a reasonable basis for not classifying workers as employees outside the three statutory safe harbor categories can be entitled to relief under a judicial safe harbor. See *Critical Care Register Nursing, Inc.,* (DC PA 1991) 68 AFTR 2d 91-5716.

Helen Carney formed and managed both Nelly LLC and its successor, Nelly Home Care, Inc. (collectively, Nelly). Both companies were providers of home health care services in the Philadelphia, PA area, matching companions with elderly clients. Carney herself was a companion before starting her own business. While working as a companion, she learned that some home care service providers treated their workers as independent contractors.

After forming Nelly in 2004, Carney conducted a survey of 20 home care companies to determine how they classified their companions for tax purposes. Seven of these companies classified companions as independent contractors. The remaining companies treated them as employees.

In 2009, she attended a mandatory conference at the Pennsylvania Department of Health. At the conference, Carney was told that home care registries, the classification under which Carney registered Nelly, treated workers as independent contractors.

In the mean time in 2007, IRS audited Carney's personal income tax returns for the 2004 and 2005 tax years relative to her reported income and expense deductions. Carney provided IRS with information about Nelly, including documents relating to gross receipts, expenses, and copies of independent contractor agreements. As a result of the audit, IRS concluded Carney had underreported her income, commingled business and personal accounts, and charged 80% of her personal expenses through Nelly. Consequently, IRS adjusted Carney's personal tax liability.

IRS again audited Carney's personal income tax returns in 2011. This time, the audit was resolved with a "no change" determination.

IRS later commenced an employment tax audit of Nelly. It determined that Nelly owed a combined total of $4,000 in back employment taxes for tax years 2008-2012. Nelly paid the tax and promptly sought a refund.

After hearing nothing from IRS for six months, Nelly brought an action in district court, claiming it was entitled to relief under the safe harbor provisions of Section 530.

The judge in that case, Judge Dalzell, granted Nelly's motion for summary judgment. *(Nelly Home Care, Inc.,* (DC PA 5/10/2016) 117 AFTR 2d ¶ 2016-680) He concluded that, although Nelly was not protected by the statutory industry practice or prior audit safe harbors, Nelly had a reasonable basis for treating its companions as independent contractors. In reaching this conclusion, the court considered the cumulative effect of Carney's experience and research, the personal IRS audits which included a review of Nelly's business practices, and the abovementioned Pennsylvania rules. He found that these factors together provided a reasonable basis for Nelly's decision to classify companions as independent contractors.

Nelly brought the current case in which it contended that it was entitled to fees and costs because it won on summary judgment.

The court, noting that the fact that a taxpayer wins a case against IRS on summary judgment does not mean that IRS's position was not substantially justified, found IRS's position was substantially justified and thus did not grant any award of fees or costs.

The court said, citing the Supreme Court's holding in *Pierce v. Underwood,* (S Ct 1988) 487 U.S. 552, that "substantially justified" means IRS had a reasonable basis in both law and fact. The position taken need not have been correct, only reasonable. In determining whether IRS's position is substantially justified, the court first considers "the available objective indicia of the strength of IRS's position." Objective indicia include the terms of any settlement, the stage of litigation where the merits were decided, and the views of other courts on the merits. If the objective indicia are inconclusive, the court makes its own assessment of the merits of IRS's position.

Here, the court said, objective indicia were inconclusive. There was no settlement. The facts were undisputed. With respect to the legal question, there were no cases where courts had considered the position taken by IRS in this litigation.

Nelly did not succeed in demonstrating that it was entitled to relief under the statutory bases under Section 530. Instead, it convinced Judge Dalzell that it had a reasonable basis for classifying its companions as independent contractors despite the absence of a statutory basis. The reasonable basis result could have gone either way. The court here noted, "Indeed, having reviewed the record, we cannot say we would have ruled as Judge Dalzell had."

Nelly's survey of other home care companies revealed that only seven of the twenty companies treated workers as independent contractors. It was not unreasonable for IRS to question Nelly's relying on a minority of home care companies' treatment of workers as independent contractors.

The prior audit was of Carney's personal tax returns. It was not of Nelly's returns. Hence, the prior audit safe harbor was clearly not available.

There was no legal precedent, decisional or regulatory. Consequently, IRS did not take a position that was contrary to the law. The absence of any precedent justified IRS's pressing for a ruling that would not only resolve the classification issue in this case, but provide guidance in future cases.

Okorogu, TC Memo 2017-53.

Wife who was physically and mentally abused by her husband filed a joint return with him under the "tacit consent rule." The Court also granted her action for innocent spouse relief under §6015(f).

§6061(a) provides that any return or other document required to be made under any provision of the internal revenue laws or regulations must be signed. Regulation §1.6012-1(a)(5) requires signatures of both spouses on a joint tax return. Form 1040 provides space for signatures of both spouses and states: "If a joint return, both must sign." Instructions for Form 1040 warn that a Form 1040 is not considered a valid tax return unless signed by a taxpayer.

Under the "tacit consent rule," where one spouse files a return that is labeled as a joint return but is signed only by that spouse, the courts will find that there is a joint return if they believe that the other spouse gave his or her tacit consent. (*Howell,* (1949, CA6) 38 AFTR 63) It is a narrowly tailored exception to the requirement that both spouses sign a joint tax return. Courts use it mostly in situations where one of the spouses signs a return for the other and the other spouse later disputes the issue of joint and several liability for the deficiencies and penalties arising out of a purportedly joint tax return. (*Reifler,* TC Memo 2013-258)

If, taking into account all the facts and circumstances, it is inequitable to hold a taxpayer (i.e. an individual who has made a joint return) liable for any portion of any unpaid tax or deficiency or both, and relief is not available to that taxpayer under the innocent spouse rule in §6015(b) or the separate liability election rule in §6015(c), IRS may relieve the taxpayer of liability for that unpaid tax or deficiency. (§6015(f))

Revenue Procedure 2013-34, 2013-43 IRB 397, provides guidelines that IRS follows in determining whether a requesting spouse qualifies for equitable relief under §6015(f).

Husband and Wife had been Nigerian residents. They moved to the U.S. and married.

Husband emotionally and physically abused Wife throughout their marriage. Husband was highly controlling of Wife's life inside and outside the home; in particular, he monitored and restricted Wife's social interactions. At various times, he physically attacked her; she obtained several temporary restraining orders against Husband.

Husband controlled all decisions regarding spending and family finances. Before 2014 Wife did not know of any obligation to file a tax return with IRS reporting her income. Wife was not required to file formal tax returns in Nigeria, and Husband never informed her of the requirement to do so in the U.S. Forms 1040 electing the status of married filing jointly and containing both spouses' income and deductions were filed timely for Husband and Wife for tax years 2011 and 2012. Although the returns for 2011 and 2012 purported to bear Wife's electronic signature, Wife did not participate in the preparation of these returns and did not sign them.

In May 2012 Husband left the U.S. and moved back to Nigeria. Husband made at least a couple of trips to the U.S. in 2012. For 2013 and subsequent years, Wife filed as head of household.

IRS sent a notice of deficiency to Husband and Wife on May 5, 2014 with respect to the 2011 and 2012 returns. On August 1, 2014, Husband and Wife filed a joint petition in the Tax Court that was drafted by shared counsel. On or around January 21, 2016, Wife obtained new counsel. Shortly thereafter Wife moved for and was granted leave to file a separate amended petition. In the amended petition, Wife raised a claim to relief from joint and several liability under §6015.

The Court applied the tacit consent rule and found that the 2011 and 2012 returns were joint returns.

Husband opposed the granting of equitable relief for Wife on the ground that the returns that he caused to be filed for himself and Wife for the years in issue were not valid joint returns. In support of his position, Husband cited Wife's testimony that she knew nothing of the preparation or filing of the returns for the years in issue, that her purported signature on the returns was a forgery, and that she was unaware of any tax reporting obligation at the time that the returns were filed. Husband argued that because the 2011 and 2012 returns were not valid joint returns, the liabilities determined for those years should be redetermined on the basis of rates and allocation of income for married persons filing separately.

Wife and IRS argued that although Wife did not sign and did not expressly agree to Husband's filing of the returns for 2011 and 2012, the returns were valid joint returns because Wife tacitly consented to the filing of joint returns by Husband.

The Court said that, whether a joint return has been filed is a question of fact, the resolution of which depends upon the intent of the parties. To file jointly, both spouses must intend to make a joint return. The absence of the signature of one spouse does not necessarily preclude a finding of a valid joint return where the facts otherwise indicate that an income tax return was intended by both spouses to be a joint return.

The Court said that the Tax Court has considered a variety of factors in evaluating the issue of tacit consent, especially whether the nonsigning spouse filed a separate return, whether the nonsigning spouse objected to the other spouse's joint filing, and whether the couple's prior filing history indicates the intent to file jointly. See, e.g., *Heim,* (1956) 27 TC 274. Thus, a history of reliance by the nonsigning spouse on the other spouse with respect to family financial matters, including the preparation of tax returns, suggests that the nonsigning spouse consented to the other spouse's filing of the return in question. See *Estate of Campbell,* (1971) 56 TC 1. Furthermore, the inclusion of income and deductions attributable to the nonsigning spouse on the return generally will be taken as proof of the intent to file a joint return, even where the nonsigning spouse failed to give his or her express consent to the filing. See, e.g. *Federbush,* (1960) 34 TC 740.

And, the tacit consent rule has been described as an extension of the presumption of correctness that generally attaches to IRS's determinations. (*Hennen,* (1961) 35 TC 747) IRS accepted and processed the returns as the valid joint returns for Husband and Wife. IRS maintained the position throughout this proceeding that the returns submitted by Husband were valid joint returns.

H indisputably intended to file joint income tax returns with Wife for the years in issue. Husband was responsible for preparing the returns and for providing all of the information shown on them. By electing joint filing status, Husband benefited from tax rates and other items available only to joint filers, and he claimed exemptions and other deductions attributable to the family unit. When the original petition was filed in this Court, Husband filed it jointly with Wife; at that time Husband did not contend that IRS's deficiencies should be redetermined on the basis that he and his spouse should be treated as married persons filing separately. Husband raised the argument that the 2011 and 2012 returns were not valid joint returns only following the filing of Wife's amended petition.

The Court said that the situation here was unusual in that the spouse whose signature was not on the return was arguing for a joint return, while the spouse who filed the return as a joint return attempted to disavow it. Wife testified that the returns for 2011 and 2012 were prepared and filed entirely without her knowledge or consent, that she never looked at or signed those returns, and that she was not even aware at the time that those returns were filed that she had an obligation to report her income to IRS. Wife also testified that she was a "law-abiding citizen" and that she would have ensured that returns were filed for her for the years in issue had she known of the obligation to file. Wife also testified that she would have signed the exact returns prepared by Husband had he presented them to her.

The Court said that Wife's failure to object to Husband's filing or to file separate returns for the years in issue could be explained by her ignorance, at the time, of any tax reporting obligation. However, the Court said that it did not conclude that Wife's ignorance in this respect discredited her contention that she tacitly consented to Husband's filing for her for the years in issue. Wife's ignorance was due to Husband's conscious efforts to dominate family finances and to close her off from social interactions. Wife testified convincingly that she would have acquiesced in Husband's filing and signed the returns had Husband presented them to her at the time that he prepared them. Her simple lack of knowledge of the filing requirement was not evidence of any desire or intent not to file joint returns with Husband for the years in issue.

Wife's actions following the time that she learned of a tax reporting obligation were consistent with her assertion that she tacitly consented to the joint filings made by Husband for 2011 and 2012. When Wife filed a separate return for tax year 2013, she elected head of household status for herself, but she made no attempt to amend or resubmit the earlier return filed for her for 2011 or 2012. The record of Wife's administrative filings and her actions before the Court, including her amended petition arguing that she was entitled to relief from joint and several liability, showed that she has consistently ratified and adopted the returns that Husband filed for the years in issue.

On balance, the Court said, the evidence led it to conclude that Wife approved or at least acquiesced in Husband's filing of joint returns for 2011 and 2012. Wife tacitly consented to filing joint income tax returns with Husband for 2011 and 2012, and so the returns for those years were valid joint returns.

Noting that Revenue Procedure 2013-34 provides that abuse and restricting access to necessary financial information are factors that strongly favor granting equitable relief under §6015(f), the Court granted Wife relief under that Code section.

The Court said that Wife's testimony and supporting documentation that she provided established that she suffered from near constant emotional and physical abuse during the time that Husband lived with her and the children in California. Husband strictly and secretively controlled the family's finances, and Wife reasonably feared his retaliation for any attempt to question or challenge his decisions. After Husband moved to Nigeria in May 2012, he continued to instill fear in and exercise control over Wife and the children. Husband's counsel's attempts to discredit Wife's testimony to this effect, arguing that Husband was physically removed from the household and that Wife had control over her own bank account from May 2012 onwards, ignored the realities of an abusive relationship and the fact that Husband returned to California multiple times during that period.

Palomares, (CA 9 5/31/2017) 119 AFTR 2d ¶ 2017-806.

The Court of Appeals for the Ninth Circuit, reversing and remanding a decision of the Tax Court, has held that a taxpayer who filed Form 8379, Injured Spouse Allocation, when she should have filed Form 8857, Request for Innocent Spouse Relief, met the requirements of the "informal claim doctrine" and that therefore her claim for innocent spouse relief was timely.

In general, a refund claim must be filed within three years from the later of when the return was filed or two years from when the tax was paid. (§6511(a)) If the taxpayer did not file the claim within the three-year period, the amount of the refund is limited to the portion of the tax paid in the two years "immediately preceding the filing of the claim." (§6511(b)(2)(B))

While a refund claim is typically filed on an official IRS form, an informal claim may be recognized if it: (1) is timely; (2) asserts a right to a refund; (3) describes the tax, tax year, and basis for the claim; and (4) has some written component. (*Pala Inc. Employees Profit Sharing Plan and Trust Agreement v. U.S.,* (CA 5 2000) 86 AFTR 2d 2000-7079) The informal claim must put IRS on actual or constructive notice that the taxpayer is currently asserting a right to a refund, and simply notifying IRS of an intent to file a claim in the future is insufficient. (*Mobil Corp v. U.S.,* (Ct Fed Cl 2005) 96 AFTR 2d 2005-6230)

Generally, when spouses file a joint tax return, each spouse is jointly and severally liable for the tax due. (§6013(d))

However, an election under §6015(c) treats former spouses that filed a joint return as if they had filed separate returns, and each spouse's liability is limited to that portion of the deficiency properly allocable to that spouse. (§6015(c)(1), §6015(d)(3)) And, if, taking into account all the facts and circumstances, it is inequitable to hold a taxpayer (i.e. an individual who has made a joint return) liable for any portion of any unpaid tax or deficiency or both, and relief is not available to that taxpayer under the innocent spouse rule in §6015(b) or the separate liability election rule in §6015(c), IRS may relieve the taxpayer of liability for that unpaid tax or deficiency. (§6015(f))

Form 8379, Injured Spouse Allocation, is the form that is filed by one spouse (the injured spouse) on a jointly filed tax return when the joint overpayment was (or is expected to be) applied (offset) to a past-due obligation of the other spouse. Form 8857, Request for Innocent Spouse Relief, is the form to be filed by a spouse who filed a joint return, to request relief from joint and several liability under various circumstances.

The taxpayer, Ms. Palomares, spoke very little English. For 1996, Ms. Palomares filed a married filing jointly Form 1040 with her spouse, Jesus Palomares. During 2005, Ms. Palomares separated from Mr. Palomares. She filed Federal income tax returns, using head of household status, for 2005, 2006, 2007, and 2008.

During the period from April 15, 2006 through April 15, 2009, IRS applied refunds from Ms. Palomares's 2005-2008 returns against her joint 1996 tax liability with Mr. Palomares.

Ms. Palomares requested refunds of tax for 2006 and 2007. When the refunds were not received, she sought the aid of a legal clinic, which helped her fill out a Form 8379. On July 1, 2008, Ms. Palomares submitted the Form 8379 requesting a $3,254 refund regarding her 2007 tax year. On September 24, 2008, IRS sent Ms. Palomares a letter acknowledging receipt of the Form 8379 and determining that she did not qualify for the type of relief sought on that form. IRS's letter went on to explain that "Form 8379 is valid for married filing joint returns only" and that Ms. Palomares "may have intended to file Form 8857 for the Innocent Spouse relief." IRS enclosed a copy of Form 8857 with the September 24 letter. Ms. Palomares did not file a refund suit with respect to the denial of relief requested in the Form 8379. When she received the September 24 letter, she understood that she was not going to receive her refund at that time but did not understand that she needed to do more to pursue her claim.

In addition to having a limited ability to communicate in English, Ms. Palomares experienced numerous personal problems from 2008 through 2010. In 2008, Mr. Palomares physically abused Ms. Palomares and threatened her with a gun. And, during this period, Ms. Palomares's wages were garnished because of Mr. Palomares's outstanding business obligations.

On January 19, 2010, Ms. Palomares and Mr. Palomares divorced. Ms. Palomares learned from the attorney who was assisting her in the divorce proceeding that IRS had applied her refunds to the 1996 joint tax liability. In August 2010, Ms. Palomares mailed a Form 8857 seeking a refund of the 2006, 2007, and 2008 credits that were applied against her and Mr. Palomares's 1996 joint Federal income tax liability. IRS informed her that she would be granted that relief only with respect to payments made within two years from the date of her Form 8857.

Ms. Palomares brought suit in the Tax Court. The Tax Court held that the Form 8379 did not qualify as an informal claim for refund and that the period to request a refund for 1996 of the credits attributable to the 2006 and 2007 tax years had expired when she filed Form 8857. As a result, it held that IRS properly denied Ms. Palomares a refund of those credits. (*Palomares,* TC Memo 2014-243)

The Ninth Circuit, reversing the Tax Court, held that Ms. Palomares filed an informal claim when she filed Form 8379, and remanded to the Tax Court to order IRS to grant Ms. Palomares a refund for her 2006 and 2007 tax year overpayments.

The Court concluded that, for two reasons, Ms. Palomares's Form 8379 fairly apprised IRS that Ms. Palomares was seeking innocent spouse relief from her 1996 liability. First, IRS had been crediting Ms. Palomares's tax overpayments-which were associated with returns she filed separately-to liability on the 1996 return that she filed jointly. The only form of relief that made any sense under these circumstances was innocent spouse relief. Second, in responding to Ms. Palomares's Form 8379, IRS informed Ms. Palomares that to request innocent spouse relief, she should file a Form 8857, not a Form 8379.

The Court said that the equities weighed in favor of granting Ms. Palomares relief under the informal claim doctrine. Ms. Palomares spoke little to no English during the relevant period. She was the subject of domestic abuse. She was not responsible for the deficient 1996 payment. And her improper filing of the Form 8379 was the result of incorrect advice from a volunteer attorney. Because Ms. Palomares's Form 8379 sufficiently gave notice to IRS that Ms. Palomares was seeking a refund on the ground that she was an innocent spouse, and the equities weighed in her favor, the Tax Court should have granted Ms. Palomares relief by letting her Form 8379 toll the limitations period until the Form 8857 was filed.

IRS noted that Ms. Palomares's Form 8379 indicated that she was seeking a refund on her 2007 overpayment but was silent as to her 2006 return.

The Court said that "whether Ms. Palomares put IRS on notice as to her 2006 return is a highly fact intensive inquiry that lacks hard and fast rules and should focus on all the surrounding circumstances and the claim as a whole." Here, once IRS received Ms. Palomares's Form 8379 and proceeded to review her 2007 request, it was on notice that Ms. Palomares's liability stemmed from the 1996 underpayment, and IRS had been crediting her overpayments against this liability since 2006. "There can be no serious question that IRS was on notice of her 2006 overpayment as well."

Paychex Business Solutions, LLC, et al v. U.S. (DC FL 06/22/2017) 119 AFTR 2d ¶ 2017-893.

A district court in Florida has held that a number of professional employer organizations (PEOs) were §3401(d)(1) statutory employers of their clients' employees. As such, the PEOs had standing to sue for a refund of the employer portion of FICA tax that they had overpaid.

Under §3401(d)(1), if the common law employer does not have control of the payment of wages, the term "employer" means the person having control of the payment of wages. Although the Code imposes only Federal income tax withholding obligations on the §3401(d)(1) (i.e., statutory) employer, case law has extended such an employer's obligations to include withholding and payment of FICA and FUTA taxes.

FICA taxes consist of Social Security (i.e., Old Age, Survivors, and Disability Insurance) tax, and Medicare (Hospital Insurance) tax. The employer and employee share of Social Security tax (6.2% for each) is paid on wages up to a wage base (currently $127,700), while Medicare tax (generally 1.45% for each) is paid on the employee's total wages.

Observation: Under current law, higher-income employees pay a 0.9% additional Medicare tax on wages in excess of a statutory amount.

If, during a single calendar year, an employee receives wages from more than one employer, the Social Security wage limitation with respect to the employer's share does not apply to the total received from all the employers. Rather, the limitation applies separately to the wages received from each employer. (Regulation §31.3121(a)(1)-1(a)(3)) There are exceptions for successor employers and motion picture project employers. If more than the maximum Social Security tax is withheld from an employee's wages because he worked for two or more employers during the year, the excess is a credit against income tax on the employee's return for the year.

Paychex Business Solutions, LLC, et al, are professional employer organizations (collectively, PEOs) headquartered and licensed in Florida.

The PEOs would enter into a client service agreement (CSA) with each client company customer to provide all employer payroll functions and certain human resource functions. The CSAs generally provide that the PEOs assumed responsibility for the payment of wages to the clients' employees (worksite employees) during the terms of the CSAs without regard to whether the client companies first paid such amounts to the PEOs. Additionally, the CSAs provided that the PEOs assumed full responsibility for the reporting, collection, and payment of payroll taxes to IRS.

Typically, two days before the date when worksite employees were paid, the PEOs got certain payroll information (e.g., hours and rates of pay) from the client companies. The PEOs, which had the worksite employees' Forms W-4 and knew of their necessary payroll deductions for benefit plans and garnishments, then calculated the appropriate amount of wages and payroll taxes. The PEOs would initiate a debit to the client companies' bank accounts via automated clearing house (ACH), which would include amounts for the employees' compensation and FICA taxes. The ACH process did not ensure that the PEOs received payment from the client companies before the issuance of payroll checks or direct deposits to the worksite employees. There was a lag of at least three business days between when the PEOs' debit was presented to each client company's bank and when the PEOs could confirm that the transfer of funds from each client company was successful (or that one or more client companies had insufficient funds).

On the same date that the PEOs debited the client companies' bank accounts, the PEOs arranged for the direct deposits or checks for the worksite employees' wages. Thus, the initiation of wage payments to the worksite employees occurred before the PEOs had confirmation that the client companies had sufficient funds to cover the corresponding debit to the client companies' bank accounts. Once the PEOs initiated the direct deposits for the payment of the employees' wages, the direct deposits could not be changed.

During the many instances in which a client company did not have sufficient funds in its bank account from which the PEOs could debit the amount owed for that pay period, the PEOs would not learn of the shortfall until after they had made the wage payments to the worksite employees. In those cases, the PEOs would have to seek payments from the client companies through collection actions (which did not guarantee payment).

The PEOs used their own bank accounts to make the wage payments to the worksite employees, as well as to pay the payroll taxes to IRS. The client companies had no authority over, or access to, these bank accounts.

Each time the PEOs entered into a CSA with a new client company, the PEOs restarted the Social Security taxable wage base for that client company's worksite employees. IRS and the PEOs agreed that this decision was erroneous, and in some instances led to the overpayment of the employer's portion of the Social Security tax. The PEOs paid the employer portion of the Social Security tax associated with the restarting of the Social Security taxable wage base from their own bank accounts.

Observation: This would not have happened if the PEOs had been certified PEOs (CPEOs). Under §3511, a CPEO and no other person is to be treated as the employer liable for employment taxes with respect to wages paid by the CPEO to a work site employee performing services for any customer of the certified PEO. Under §3511(b)(1), a CPEO that enters into a service contract with a customer for a worksite employee who's performing services for the customer is treated as a successor employer, and the customer's treated as a predecessor employer during that service contract's term. Under the successor employer rules, when certain requirements are met, wages paid by the predecessor are treated as if paid by the successor for purposes of applying the social security wage base (and for applying the additional Medicare tax withholding threshold). The first PEO certifications were effective January 1, 2017.

The PEOs reported their payment of the employer portion of the Social Security tax on Forms 941 (Employer's Quarterly Federal Tax Return) using their own names, addresses, and employer identification numbers (EINs). The client companies no longer filed these federal employment tax returns after entering into CSAs with the PEOs, and the PEOs did not file these federal employment tax returns using the names, addresses, or EINs of the client companies. The PEOs did this because they assumed full responsibility for the reporting, collection, and payment of payroll taxes for worksite employees, and thus, the PEOs considered themselves to be those employees' statutory employers.

After the PEOs realized that they had erroneously restarted the Social Security taxable wage base for the client companies' worksite employees, they filed Forms 941-X (Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund) to claim refunds for the overpayments of the employer's portion of the Social Security taxes for several tax periods from 2009 through 2012. IRS denied the PEOs' claims for refunds.

The court found that the PEOs were the §3401(d)(1) statutory employers of the worksite employees, because the PEOs actually controlled the accounts from which the wage payments were made. The client companies had no authority over, or access to, these bank accounts.

The court presented a detailed survey of relevant cases to demonstrate that the trend in the case law indicated that the person or entity that controls the bank account from which wages are paid is the §3401(d)(1) statutory employer. For example, in *Winstead* (1997, CA4) 79 AFTR 2d 97-1977, the taxpayer owned land that was farmed by sharecroppers, who were accountable for their hired help. However, the sharecroppers could not pay the hired help until after the crops were sold. Therefore, the taxpayer paid the help from his checking account, over which the sharecroppers had no authority, then deducted what he paid from the sharecroppers' share of the crop proceeds. The taxpayer was held to have control of the payment of wages to the hired help and thus was the §3401(d)(1) statutory employer because he paid the hired help directly from his own account, over which the sharecroppers had no authority. The Federal Claims Court reached a similar result in *Consolidated Flooring Services* (Ct Fed Cl, 1997) 80 AFTR 2d 97-6100, which involved carpet installers. And in *Total Employment Company Inc.,* (DC Fla, 2004) 93 AFTR 2d 2004-1036, dealing with an employee leasing company, a district court in Florida held that the party that actually makes the wage payments is the party that has control over the wages and thus is liable to IRS for payroll taxes.

The court rejected IRS's arguments that (1) the PEOs were merely conduits for the client companies' funds because the client companies' accounts were debited before the payment of wages to the worksite employees; and (2) the client companies were the entities actually in control of wage payment to the worksite employees, because these payments were contingent on or proximately related to prior receipt by the PEOs of the client companies' funds. The court said these arguments had been rejected by earlier cases (e.g., Total Employment). Additionally, the court pointed out that the PEOs were not able to confirm that the client companies that paid via ACH had sufficient funds in their accounts before the PEOs made the wage payments to the worksite employees. This uncertainty regarding the sufficiency of the client companies' funds before the PEOs made the wage payments undercut IRS's conduit and control arguments.

The court also rejected IRS's related argument that the PEOs must have exclusive control over the payment of wages to be treated as statutory employers, and such exclusive control was missing because the wage payments were contingent on or proximately related to prior receipt by the PEOs of the client companies' funds. The correct inquiry, according to the court, was whether the PEOs had exclusive control over the bank accounts from which the wage payments were made, and the undisputed evidence showed that the PEOs did have such exclusive control.

In general, a taxpayer may begin a suit against the U.S. only if there has been a specific waiver of sovereign immunity. IRS argued that the district court lacked subject matter jurisdiction, because the U.S. did not waive its sovereign immunity to be sued by the PEOs, whom IRS characterized as third-party, volunteer payers of the FICA taxes at issue. The court rejected this argument because it had already found that the PEOs were the §3401(d)(1) statutory employers of the worksite employees, and as such, were the taxpayers responsible for reporting and paying the FICA taxes at issue.

IRS alternatively argued that the PEOs lacked standing to sue, because they did not have a financial interest in the amounts sought to be refunded (due to the client companies reimbursing the PEOs for the amounts the PEOs paid in FICA taxes). The court rejected this argument and ruled that the undisputed facts showed that the PEOs were the ones that actually made the FICA payments to IRS from accounts that solely belonged to, and were controlled by, the PEOs. The fact that the PEOs' payment of the FICA taxes was from money controlled by them, was sufficient to give them standing to seek the refunds.

Pfizer, Inc. v. U.S., (DC NY 5/12/2017) 119 AFTR 2d ¶2017-759.

A district court has dismissed for lack of jurisdiction a parent corporation's 28 USC 1346(a)(1) action to recover $8.3 million in interest that it claims IRS owed on a refund that was paid late. The court found that the suit was subject to the 2-year limitations period under §6532(a)(1), and the taxpayer's failure to timely file meant that the court lacked jurisdiction.

A taxpayer must file a timely refund claim with IRS before bringing a refund suit. (§7422(a)) If IRS denies the claim, the taxpayer must file its refund suit within two years from the date IRS mails the taxpayer a notice of disallowance. (§6532(a)(1)) This time bar is jurisdictional because "[a] statute of limitations requiring that a suit against the Government be brought within a certain time period is one of [the] terms" that defines the scope of the Government's waiver of sovereign immunity. (*U.S. v. Dalm,* (S Ct 1990) 65 AFTR 2d 90-1210)

28 USC 1346(a)(1) provides, in relevant part: "The district courts shall have original jurisdiction...of...any civil action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected under the internal-revenue laws."

Pfizer, Inc. timely filed a consolidated federal income tax return for the year ended December 31, 2008 on September 11, 2009, before the extended due date, and received an electronic return acknowledgement the same day showing that IRS accepted the return. The return showed an overpayment of nearly $770 million, of which Pfizer requested a refund of $500 million and the remaining $270 million to be applied to its 2009 estimated tax.

Pfizer never received its refund and made numerous inquiries with IRS. In February 2010, IRS confirmed that the refund had not been sent and, on Mar, 19, 2010, directly deposited the refund directly in Pfizer's bank account without paying any interest.

Pfizer subsequently filed a claim for refund on March 13, 2013, requesting allowable interest on the refund under §6611, which IRS disallowed. Pfizer subsequently filed suit on March 11, 2016 seeking $8.3 million in interest for the period from March 15, 2009, until March 19, 2010.

In October of 2016, IRS sought dismissal of Pfizer's suit for lack of jurisdiction, which the court denied. The court held that it had jurisdiction under 28 USC 1346(a)(1) to hear cases, such as this one, where the only issue is interest owed to a taxpayer on overpaid taxes.

In the instant proceeding, IRS again sought dismissal for lack of jurisdiction on the basis that Pfizer failed to file its suit within §6532 's 2-year limitations period.

The court reasoned that, while 28 USC 1346(a)(1) is phrased broadly, it must be "read in conformity with other statutory conditions which qualify a taxpayer's right to bring a refund suit." (Dalm) These include both §7422(a), which requires a taxpayer to first file a claim for refund with IRS, and §6532(a)(1), which sets out a 2-year period within which a proceeding under §7422(a) must be brought.

In this case, Pfizer properly filed its refund claim with IRS, which IRS denied in a letter sent by certified mail and received by Pfizer on May 10, 2013-which began the running of the 2-year period under §6532(a)(1). Because Pfizer brought suit over two years later, on March 11, 2016, the action is time-barred.

The court rejected Pfizer's arguments that it was not subject to the 2-year filing limitation. Pfizer cited a number of cases in support of not applying the 2-year limitations period, but the court found they were not commenced in a district court under 28 USC 1346(a)(1) and were thus distinguishable.

Accordingly, the court granted IRS's motion to dismiss for lack of jurisdiction.

Riggins, TC Memo 2017-106.

IRS's processing of a taxpayer's return, after it issued a notice of deficiency based on an IRS-prepared substitute for return (SFR) and after the taxpayer filed her petition seeking the Court's redetermination of her tax liability, did not limit IRS's authority to rely upon that notice of deficiency. It also ruled on an aspect of the imposition of the failure-to-pay penalty where there is an SFR.

§6213(a) provides that a taxpayer generally has 90 days after a notice of deficiency is mailed, to file a petition with the Tax Court and that if a petition is filed, IRS may not assess tax resulting from a deficiency until that Tax Court case is final. If a taxpayer files a petition with the Tax Court, IRS must assess the entire amount redetermined as the deficiency by the decision of the Tax Court. (§6215(a))

§6212(d) provides that IRS may, with the consent of the taxpayer, rescind any notice of deficiency mailed to the taxpayer.

§6651(a)(2) imposes a penalty for failure to timely pay the amount of tax shown on a return unless the taxpayer shows that the failure to pay was due to reasonable cause and not willful neglect.

If a taxpayer fails to file a return when required, IRS can prepare a return based on its own knowledge and on information it obtains through testimony or otherwise. (§6020(b)(1) and Regulation §301.6020-1(b)(1)) Such an IRS-prepared return is sometimes referred to as an SFR. An SFR made by IRS under §6020(b)(1) and Regulation §301.6020-1(b)(1) and signed by IRS is good and sufficient for all legal purposes, except insofar as any federal statute expressly provides otherwise. (§6020(b)(2); Regulation §301.6020-1(b)(3))

Ms. Riggins, a lawyer, did not file a Federal income tax return for her 2012 tax year before receiving a notice of deficiency for that year. IRS prepared an SFR pursuant to §6020(b) (which Riggins claimed she did not receive) and, on October 20, 2014, issued a notice of deficiency based on that SFR. The notice of deficiency reflected $148,605 in gross receipts from her work as an attorney and included a tax deficiency and penalties, including the §6651(a)(2) failure-to-pay penalty. It also advised Riggins that IRS would accept her 2012 tax return and that filing that return might reduce the amount due.

On December 30, 2014, after IRS had issued the notice of deficiency, Riggins submitted her Form 1040, U.S. Individual Income Tax Return, for 2012. On Schedule C, she reported $122,356 in gross receipts from her law practice for 2012. IRS conceded that this amount was correct. The return claimed that she was owed a refund.

Riggins timely filed her petition, in which she stated: "Pursuant to my completed 2012 IRS Form 1040, I am owed a refund. Accordingly, I do not owe any taxes to IRS for the 2012 tax year; and, therefore, my return was timely filed." On or about February 23, 2015, IRS processed Riggins's 2012 Form 1040 and offset her claimed overpayment against a nontax debt. On March 30, 2015, IRS filed an Answer denying Riggins's allegations that she did not owe any tax and that her return was timely filed but not otherwise addressing her 2012 Form 1040.

At trial, Riggins argued that IRS had voluntarily redetermined her tax liability by accepting the 2012 Form 1040 that she had filed after the notice of deficiency was issued. Therefore, she argued, IRS should be precluded from offering any evidence inconsistent with the redetermined tax liability and no longer could rely upon the original notice of deficiency.

The Court held that IRS's processing of Riggins's 2012 Form 1040 and offset, after it issued the notice of deficiency and after she filed her petition seeking the Court's redetermination of her tax liability, did not limit IRS's authority to rely upon that notice of deficiency.

The Court said that Riggins invoked the Court's jurisdiction by filing her petition for redetermination, which had the effect of restricting IRS's ability to assess or collect the taxes determined to be owed in the notice of deficiency until the Court's decision became final. See §6213. Because she filed a petition, IRS was going to have to assess the entire amount that the Court determined to be a deficiency in its decision. See §6215.

The Court said that Riggins was seeking to "end-run" the statute that gave the Court exclusive jurisdiction over the tax year at issue once she filed her petition.

Riggins cited *Smaczniak,* (CA 5 1993) 72 AFTR 2d 93-5342, and argued that when IRS accepts a tax return filed after the issuance of a notice of deficiency and voluntarily redetermines the tax liability, IRS waives its right to rely on its original tax liability determination.

The Court said that Smaczniak did not support Riggins's position. In Smaczniak, the main issue was whether res judicata applied in a subsequent proceeding involving the same claim and the same tax year. The years at issue in Smaczniak were 1984-87, but the taxpayer-husband had been before the Court in a prior proceeding for tax years 1980-83. In that prior case, the Court entered a final decision against the taxpayer-husband because he had failed properly to prosecute his case and failed to comply with the Court's rules. After that final decision, and while an appeal was pending, the taxpayers submitted joint tax returns for 1980-83, the years at issue in the prior case, and IRS accepted those returns and redetermined the amounts of the taxpayers' tax liabilities for those years. In Smaczniak, the taxpayers attempted to raise issues relating to tax years 1980-83. The Fifth Circuit rejected IRS's affirmative defense of res judicata, reasoning that IRS may not rely on a prior judgment of a court regarding a taxpayer's deficiency when IRS has, subsequent to that court's judgment, voluntarily redetermined the amount of the taxpayer's deficiency. By voluntarily redetermining Mr. Smaczniak's tax liability, IRS in effect waived its right to rely on Mr. Smaczniak's liability as originally determined by the Tax Court.

The Court here said that the Fifth Circuit in Smaczniak was careful to limit its holding, specifying that it applied only for purposes of res judicata and only in limited circumstances. Therefore, it said, Smaczniak does not support Riggins's argument that IRS was precluded from relying on the notice of deficiency or that she no longer bore the burden of proving that the notice of deficiency was erroneous.

The Court went on to say that Riggins did not establish that IRS's processing of her return and offset of her nontax debt was anything other than an error. Riggins did not present, nor was the Court aware of, any cases holding that postpetition processing of a tax return and issuance of a refund or offset constitutes a binding settlement of the liability at issue in the petition. Nor did she so argue.

The Court said that Riggins's contention that IRS no longer could rely on the notice of deficiency was similar to an argument that IRS had rescinded the notice of deficiency even though the formal procedures for doing so were not followed. This argument consistently has been rejected. §6212(d) requires mutual consent by IRS and the taxpayer to effect a rescission of a notice of deficiency. The Court said that it knew of no authority deeming a notice of deficiency rescinded in absence of a formal rescission. In either a settlement or a formal rescission, there must be a meeting of the minds between the parties. That did not happen here.

Whether taxpayer was notified of IRS-prepared return did not affect imposition of penalty. The Court also held that the fact that Riggins may not have received notice that the SFR was prepared had no effect on whether the §6651(a)(2) failure-to-pay penalty applied. §6651(a)(2) requires a return, not notice of payment due, and the SFR constituted the return for the purposes of calculating the penalty. There is no requirement in §6020 that IRS send notice to a taxpayer that an SFR has been prepared, and there is no requirement in §6651 that the taxpayer receive notice that the SFR was prepared in advance of IRS assessing the penalty for failure to timely pay.

Rosen, TC Memo 2017-52.

There was nothing wrong with IRS's notice of deficiency that did not take into account restitution payments made by the taxpayer. Restitution payments are not amounts "assessed as a deficiency"; i.e., they are not subtractions in §6211(a) 's calculation of a deficiency. Rather, the restitution payments were credits against the deficiency.

A deficiency is the excess of the "correct tax," i.e., the amount of the income tax imposed by Subtitle A (§6211(a)) over the sum of the tax shown on the taxpayer's return (§6211(a)(1)(A)), and the amounts previously assessed (or collected without assessment) as a deficiency (§6211(a)(1)(B)), less the amount of any rebates made. (§6211(a)(2))

IRS is authorized to make various types of assessments. (§6201) The most common types are summary assessments, which can be immediately assessed, and deficiency assessments. A deficiency assessment requires IRS to follow a number of statutory steps before it may undertake to collect the deficiency. §6212(a) provides that if IRS determines that there is a deficiency, it is authorized to send a notice of the deficiency to the taxpayer. IRS generally cannot assess a deficiency unless a notice of deficiency has been issued. See §6213(a). As income tax is subject to the deficiency procedures, an assessment generally cannot be made until the taxpayer waives the restrictions prohibiting assessment; the 90-day period for filing a Tax Court petition expires following the issuance of a notice of deficiency; or, if the taxpayer timely files a petition with this Court, the Court's decision becomes final. (§6213(a); Regulation §301.6213-1(a)(2))

18 USC 3556 provides for mandatory and discretionary court-ordered restitution to certain crime victims. IRS may issue a summary assessment with respect to restitution, i.e., it immediately assesses, without issuing a statutory notice of deficiency, the restitution ordered. (§6201(a)(4), §6213(b)(5))

The taxpayer, Mr. Rosen, filed his 1998 tax return promptly and received a refund in 1999 with respect to his 1998 return.

In 2008, Rosen was found guilty of several tax crimes with respect to his 1998 return. Pursuant to a court order, Rosen paid $776,000 of restitution.

IRS then audited Rosen and issued an examination report to Rosen over a year after the restitution payments were received; the report showed a deficiency of $392,000. Thereafter, IRS mailed Rosen a notice of deficiency that showed the $392,000 as the deficiency.

Rosen did not execute a Form 4089-B, Notice of Deficiency-Waiver, for tax year 1998. And, before the expiration of the 90-day period for filing a Tax Court petition, Rosen timely filed a petition with the Tax Court for redetermination. IRS had not assessed the deficiency for 1998, and IRS had not yet applied the restitution payments against Rosen's income tax liability for 1998.

IRS rejected Rosen's argument that, because the notice of deficiency did not give him credit for the restitution payments that he made before the notice was created, the notice of deficiency was incorrect.

The Court looked to the various elements of the deficiency calculation contained in §6211(a). First, it noted that Rosen's restitution payments were not "shown as the tax" on his 1998 return. Accordingly, Rosen's restitution payments did not discharge or reduce his deficiency determination under §6211(a)(1)(A). And, although Rosen's restitution payments were previously assessed, they were not assessed "as a deficiency"; rather, they were summarily assessed. §6213(b)(5) provides that regular deficiency procedures do not apply to amounts of restitution assessments. Thus, IRS was not permitted to reduce its determination by those payments under §6211(a)(1)(B).

Thus, restitution does not fit within the definition of a deficiency under §6211.

The Court said that, by failing to waive restrictions on assessment and filing a petition in this Court, Rosen effectively prevented IRS from doing exactly what he requested IRS to do-i.e., reduce the amount due by amounts remitted before Rosen received the notice. After the amount of Rosen's restitution order was summarily assessed, IRS determined an income tax deficiency for Rosen's tax year 1998. Upon making that determination, IRS was statutorily obligated to send Rosen a notice of deficiency before assessing the deficiency. (§6212(a)) IRS had stipulated that, following entry of a final decision in this proceeding, it would assess the income tax deficiency of $392,000, then credit Rosen's account with the restitution payments, as of the date of those payments, against that civil tax assessment.

Rubel, (CA 3 5/9/2017) 119 AFTR 2d ¶ 2017-742.

The Court of Appeals for the Third Circuit, affirming the Tax Court, has held that a taxpayer's failure to comply with §6015(e)(1)(A), which sets a deadline for submitting innocent spouse relief Tax Court petitions, fully deprives the Tax Court of its authority to hear the taxpayer's case. As a result, it dismissed for lack of jurisdiction the taxpayer's suit for innocent spouse relief despite the fact that IRS had sent the taxpayer a letter which informed the taxpayer of the wrong Tax Court petition deadline date and the taxpayer filed its petition late but by the date in IRS's letter.

Generally, when spouses file a joint tax return, each spouse is jointly and severally liable for the tax due. (§6013(d)) However, if the requirements of §6015(b), §6015(c) or §6015(f) are met, a spouse may obtain relief from joint and several liability (innocent spouse relief). An individual who requests innocent spouse relief "may petition the Tax Court (and the Tax Court shall have jurisdiction) to determine the appropriate relief available to the individual under this section if such petition is filed...not later than the close of the 90th day after the date" on which IRS mails notice of its final determination of relief available to the individual. (§6015(e)(1)(A))

The taxpayer, Ms. Rubel, and her ex-husband filed joint income tax returns from 2005 through 2008. They had an unpaid tax liability for each year. In 2015, Rubel asked IRS to relieve her from this liability under the innocent spouse relief provisions of §6015.

On January 4, 2016, IRS sent Rubel three identical notices of its final determination denying her requests for relief for tax years 2006 through 2008. On January 13, 2016, IRS sent Rubel a similar denial for the 2005 tax year. The determinations notified Rubel that, if she disagreed with IRS's decision, she could file a petition with the Tax Court to review the denial for relief within 90 days from the date of the determination. Accordingly, Rubel needed to file a petition with the Tax Court by April 4, 2016 for the 2006 through 2008 tax years and by April 12, 2016 for the 2005 tax year.

Before filing a petition with the Tax Court, Rubel submitted additional information to IRS. In a March 3, 2016 letter, IRS informed Rubel that it considered the information and still proposed to deny relief in full. IRS also notified Rubel of the following: "Please be advised this correspondence does not extend the time to file a petition with the U.S. Tax Court. Your time to petition the U.S. Tax Court began to run when we issued you our final determination on January 4, 2016 and will end on April 19, 2016. However, you may continue to work with us to resolve your tax matter."

This letter contained incorrect information. The deadlines for Rubel to petition the Tax Court regarding the final determinations were April 4 and 12, 2016, not April 19, 2016.

Rubel mailed a petition challenging IRS's determinations to the Tax Court on April 19, 2016. IRS moved to dismiss the petition, arguing that because Rubel failed to file the petition within 90 days of the date of the notices of final determination, the Tax Court lacked jurisdiction to review the petition under §6015(e)(1)(A). Rubel opposed the motion and argued that the March 3, 2016 letter started a new 90-day period for filing a petition and, in any event, that IRS should be equitably estopped from relying on the statutory deadline because the March 3 letter contained erroneous information.

The Tax Court agreed with IRS and dismissed the petition for lack of jurisdiction. Rubel appealed.

The Appeals Court, affirming the Tax Court, held that Rubel's failure to comply with §6015(e)(1)(A) deprived the Tax Court of its authority to hear Rubel's case.

The Court said that the question in this case is whether the 90-day deadline in §6015(e)(1)(A) is a jurisdictional requirement or a "claims-processing deadline." If §6015(e)(1)(A) is a claims-processing statute, Rubel's failure to comply with it may be subject to waiver, forfeiture, and equitable remedies. If, on the other hand, the deadline in §6015(e)(1)(A) is jurisdictional, the Court said, citing the Supreme Court in *U.S. v. Kwai Fun Wong,* (S Ct 2015) 135 S. Ct. 1625, Rubel's failure to comply with it deprives the Tax Court of the authority to hear the case, "even if equitable considerations would support extending the prescribed time period."

The Court noted that the Supreme Court has cautioned against finding that a deadline is jurisdictional without serious consideration (*Arbaugh v. Y&H Corporation ,* (S Ct 2006) 546 U.S. 500) and has directed courts to examine statutes to determine if they "speak in jurisdictional terms or refer in any way to the jurisdiction of the...courts." (*Zipes v. Trans World Airlines,* (S Ct 1982) 455 U.S. 385)

As a result, to determine whether a statutory deadline is jurisdictional or claims processing in nature, courts examine the text, context, and relevant historical treatment of the provision. In examining the text, they should look at the plain language to determine if it speaks in jurisdictional terms, meaning whether it speaks "to the power of the court rather than to the rights or obligations of the parties." One way Congress speaks in such terms is when it clearly labels a requirement as jurisdictional.

§6015(e)(1)(A) states that "the Tax Court shall have jurisdiction" if an individual files a petition in the court no later than 90 days after IRS mails its notice of final determination. Therefore, in circumstances like this, where Congress "clearly states that a threshold limitation on a statute's scope shall count as jurisdictional, then courts and litigants will be duly instructed and will not be left to wrestle with the issue." Accordingly, Congress's explicit statement that §6015(e)(1)(A) 's time limit is jurisdictional means that it is jurisdictional and that the Tax Court lacks authority to consider untimely petitions.

The Court said that, while it need not analyze the issue further, other tools of statutory construction bolster its conclusion. First, the context of the provision-how §6015(e)(1)(A) fits within the statute as a whole-shows that it is jurisdictional. The statute's grant of jurisdiction to the Tax Court and the time limit for activating that jurisdiction are located within the same provision. The Court noted that the Supreme Court, in Kwai Fun Wong, observed that when Congress separates a filing deadline from a jurisdictional grant, the deadline is often not jurisdictional.

Second, the Court said that the Supreme Court has historically found that filing deadlines in tax statutes are jurisdictional because allowing case-specific exceptions and individualized equities could lead to unending claims and challenges and upset the IRS's need for "finality and certainty." "Tax law...is not normally characterized by case-specific exceptions reflecting individualized equities." (*Brockamp,* (S Ct 1997) 79 AFTR 2d 97-986)

While IRS's administrative mistake in its March 3, 2016 letter may have contributed to Rubel's delay and resulting inability to have IRS's innocent spouse determination subjected to judicial review, the 90-day deadline is jurisdictional and cannot be altered regardless of the equities of the case.

Russian Recovery Fund Limited v. U.S., (CA Fed 3/14/2017) 119 AFTR 2d ¶ 2017-527.

The Court of Appeals for the Federal Circuit, affirming the Court of Federal Claims, has held IRS could proceed with collection against an indirect partner (i.e., a partner in a lower-tier partnership) whose return was filed within three years of the issuance of a final partnership administrative adjustment (FPAA) to the upper-tier partnership involved in the case. The Court also determined that another purported partnership was not a bona fide partnership, resulting in the denial of claimed losses and the imposition of penalties.

Under the TEFRA partnership audit rules, the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item) generally is determined at the partnership level. (§6221)

Observation: The TEFRA audit procedures were repealed by the Bipartisan Budget Act of 2015 (P.L. 114-74, 11/2/2015), which provided a new set of rules for auditing partnerships and their partnerships at the partnership level that generally apply (subject to an election to apply earlier) to partnership tax years that begin after December 31, 2017.

Under the TEFRA rules, if IRS decides to adjust any "partnership items," it must notify the individual partners through an FPAA. (§6226). Various Code provisions define the limitations on assessments made with respect to FPAA adjustments, and the tolling of the limitation periods (see, e.g., §6229, §6501 and discussion below). For 90 days after issuing an FPAA, the tax matters partner (TMP) has the exclusive right to file a petition for readjustment of the partnership items in the Tax Court, the Court of Federal Claims, or a *U.S. District Court.* (§6226(a)) After that period expires, other partners have 60 days to file a petition for readjustment. (§6226(b)(1)) A partner whose tax liability might be affected by the outcome of the litigation of partnership items may participate in the proceeding.

(§6224) IRS may assess additional tax liability against individual partners within one year of the final conclusion of the partnership's tax determination. (§6229(d)) The partner may contest the tax liability by paying the assessment and filing a refund action in the Court of Federal Claims. However, the partner cannot bring an action for a refund attributable to partnership items. (§7422(h))

§6501(a) generally provides that a valid assessment of income tax liability may not be made more than three years after the later of the date the tax return was filed or the due date of the tax return. Subject to exceptions and special rules, the period for assessing tax attributable to a partnership item (or affected item) for a partnership tax year will not expire before the date that is three years after the later of: (1) the date the partnership return was filed, or(2) the last day for filing the return for that year(without regard to extensions). (§6229(a))

Under Regulation §1.704-1(e)(1)(iii), when a party acquires an economic interest in a partnership, that party is only treated as a partner for tax purposes if the partnership interest is acquired in a bona fide transaction, not a mere sham for tax avoidance or evasion purposes. In determining whether a bona fide partnership exists, the Supreme Court requires that courts evaluate "whether the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits and losses or both." (*Commissioner v. Culbertson*, (S Ct 1949) 37 AFTR 1391) The Supreme Court explained in Culbertson that the question was not whether the services or capital contributed by a partner were of sufficient importance to meet some objective standard, but whether, considering all facts, including any facts throwing light on their true intent, the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

Russian Recovery Fund, Ltd. (RRF) was a limited partnership of ten partners that specialized in distressed asset transactions. Two of its partners were Russian Recovery Advisors, LLC(RRA) and FFIP, LP(FFIP). Nancy Zimmerman was an indirect partner of RRF through FFIP.

In a series of transactions, two funds operated by Tiger Management, LLC (Tiger)-one of the world's largest hedge funds managers-transferred derivative instruments known as credit-linked notes (CLNs) that it owned to RRF in exchange for an ownership interest in RRF. The CLNs had already lost nearly all of their value when Russia defaulted on its sovereign debt in August 1998, and the Russian ruble collapsed. Approximately two weeks after the transaction, Tiger sold all of its RRF partnership shares to FFIP for approximately $14.1 million, a discount of $800,000. On June 22, 1999, RRF sold 77.18% of the Tiger CLNs to another party for cash and shares. And, in 2000, RRF sold the remaining 22.82% of the Tiger CLNs on the open market.

RRF filed its 2000 return on August 14, 2001. In the 2000 tax year, RRF allocated $46.4 million of net section 988 losses (i.e., losses derived from foreign currency transactions) to FFIP.

FFIP, a partner of RRF and also a pass-through entity, filed its own 2000 partnership tax return on or before August 16, 2001. After adding the losses it received from RRF with its own losses, FFIP reported $4.2 million in losses for the 2000 tax year and $25.3 million in losses for the 2001 tax year. The original $46.4 million in section 988 losses that were allocated from RRF make up a large portion of both of these loss figures.

Ms. Zimmerman filed her 2001 return on October 15, 2002, which was less than three years before IRS issued an FPAA to RRF .

On May 10, 2005, FFIP, through its TMP, entered into an extension agreement with IRS on a Form 872-P, Consent to Extend the Time to Assess Tax Attributable to Partnership. This extension allowed IRS to assess any federal income tax attributable to the partnership items of FFIP against any partner for the period(s) ended December 31, 2001 at any time on or before August 31, 2006.

On October 14, 2005, IRS issued an FPAA to RRF for the 2000 tax year, proposing adjustments to RRF partnership items. In the FPAA, IRS proposed to disallow the $46.4 million in reported loss on RRF's 2000 RRF return, with the result of disallowing all of the claimed losses that were allocated to FFIP.

RRA, as the tax matters partner for RRF, filed a petition with the U.S. Court of Federal Claims for readjustment of partnership items under §6226(a). RRA contended that the FPAA IRS issued on October 15, 2005 for the tax year ending December 31, 2000 was issued outside the limitations period and invalid.

The Court of Claims concluded that Ms. Zimmerman could be assessed taxes on her 2001 individual return. Under §6229(d), the issuance of the FPAA to RRF on October 14, 2005 suspended the statute of limitations for one year for assessing any tax that was due to, caused by, or generated by any RRF partnership or affected items from the RRF 2000 tax year. The court reasoned that under §6229(a), the suspension of the statute of limitations for assessing Ms. Zimmerman's 2001 return applied for "any tax imposed...which is attributable to any partnership item (or affected item) for a partnership taxable year." As long as the individual partner's statute of limitations had not run prior to the issuance of the FPAA, that partner could be assessed. Simply put, this meant that Ms. Zimmerman's 2001 tax return, insofar as it reflected tax attributable to 2000 RRF partnership or affected items, was still open for assessment.

The Court of Federal Claims in a subsequent decision concluded that it was clear that Tiger had no real intention of becoming a partner in RRF and that RRF had reason to know that. The Court found that the transaction was a sham, and the transaction lacked economic substance. The court, sustaining IRS's disallowance of the losses and imposition of penalties, held that the contribution should be ignored, and the transaction should be characterized as a sale. (*Russian Recovery Fund, Ltd. v. U.S.,* (Ct Fed Cl 2016) 116 AFTR 2d 2015-5582)

Analyzing the facts, the court found that the evidence was clear that Tiger was interested in the spring of 1999 in selling its position in the CLNs. Tigre retained its interest in the partnership for approximately two weeks. At the time of Tiger's contribution to RRF, Tiger employees were already e-mailing about the next step: sale. Tiger was at all times interested in liquidity (i.e., a sale), not a partnership. Because Culbertson requires that the parties act with a business purpose and intend to join together in the present conduct of the enterprise, the court considered it highly significant that Tiger refused to sign the standard subscription agreement stating that the shares subscribed for were for investment purposes only and not with the view for a resale or distribution. Moreover, relying on IRS's experts, the court found that Tiger's entry into RRF made no sense as an investment, and its exit made no sense in terms of timing.

The Federal Circuit found that the 2005 FPAA suspended the limitations period for assessing any tax against Ms. Zimmerman that was "due to, caused by, or generated by" any partnership item on her 2001 individual tax return. The Court reasoned that the fact that IRS issued the 2005 FPAA to RRF less than three years after Ms. Zimmerman filed her 2001 individual tax return was undisputed. And, RRF allocated the loss claimed in its 2000 tax return to FFIP, much of which FFIP passed through in its 2000 and 2001 tax returns to Ms. Zimmerman, who claimed those losses on her 2001 individual tax return. Thus, the losses Ms. Zimmerman claimed on her 2001 tax return were "generated by" the loss claimed on RRF's 2000 tax return, and the 2005 FPAA suspended the limitations period for assessing taxes on these losses.

The Federal Circuit found that its interpretation of "attributable to" comported with the Code's reasonable policy of treating partnership items at their source. As §6221 generally provides, "the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) shall be determined at the partnership level." Following this principle, the tax liability of an indirect partner depends upon the partnership items, and "[a]ll adjustments required to apply the results of a proceeding with respect to a partnership...to an indirect partner shall be treated as computational adjustments." (§6231(a)(6)) Computational adjustments are "change[s] in the tax liability of a partner which properly reflects the treatment Purported return omitting income was invalid even though IRS was aware of missing items a partnership item." (§6231(a)(6)) The Court concluded that IRS's actions here fell squarely within the definition of a computational adjustment because IRS "change[d]...the tax liability of one [indirect] partner," i.e., Ms. Zimmerman, "to properly reflect the treatment...of a partnership item," i.e., the loss claimed in RRF's 2000 tax return. As a result, IRS properly adjusted the partnership item at its source.

The Federal Circuit also found no error in the Court of Federal Claims's findings that Tiger was not a bona fide partner. Under Culbertson, the focus of the inquiry is the parties' "true intent," which is determined by "considering all the facts." Contrary to RRF's assertions, the Court of Federal Claims considered the totality of the circumstances and determined that RRF's and Tiger's actions were mere formalities. The Court of Federal Claims weighed all of the relevant factors, i.e., made underlying factual findings, and applied the appropriate legal standard to these findings to determine that RRF and Tiger did not enter into a bona fide partnership.

Ryke, TC Memo 2017-144.

Innocent spouse relief did not apply to a wife who either knew or had reason to know that the liabilities shown on the joint returns she filed with her husband would not be paid. Before marrying, she was aware that her spouse had poor credit and tended not to pay his debts.

In general, married taxpayers who file a joint federal income tax return are jointly and severally liable for the tax reported or reportable on the tax return. (§6013(d)(3))

However, §6015(a)(1) provides that a spouse who has made a joint return may elect to seek relief from joint and several liability under §6015(b).

§6015(b)(1) provides that a taxpayer will be relieved of liability for an understatement of tax if: (A) a joint return was made for the tax year in question; (B) there is an understatement of tax attributable to erroneous items of the nonrequesting spouse; (C) the requesting spouse "establishes that in signing the return he or she did not know, and had no reason to know, that there was such understatement"; (D) taking into account all the facts and circumstances, it would be inequitable to hold the requesting spouse liable for the deficiency attributable to the understatement; and (E) the requesting spouse elects to invoke §6015(b) within two years after the date IRS has begun collection actions with respect to the requesting spouse.

§6015(f) provides for equitable innocent spouse relief under procedures prescribed by IRS if: (1) taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency and (2) relief is not available to the requesting spouse under §6015(b) or §6015(c). The requesting spouse has the burden of proving that he/she is entitled to relief. (*Alt,* (2002) 119 TC 306)

Revenue Procedure 2013-34, 2013-43 IRB 399, sets forth a 3-step procedure to be followed in evaluating requests for this equitable relief:

1. Section 4.01 lists seven threshold conditions which must be met (e.g., joint return was filed for relevant year and no assets were transferred between the spouses as part of a fraudulent scheme by the spouses);

2. Section 4.02 lists circumstances in which IRS will make streamlined relief determinations (e.g., requesting spouse is no longer married to the nonrequesting spouse or would suffer economic hardship if relief were not granted); and

3. Section 4.03 sets forth nonexclusive factors that IRS will consider in determining whether equitable relief should be granted because it would be inequitable to hold a requesting spouse jointly and severally liable.

The Section 4.03 factors include: (a) marital status (i.e., do the spouses remain together?); (b) economic hardship; (c) knowledge or reason to know of the requesting spouse; (d) legal obligation arising from a divorce decree or other binding agreement; (e) significant benefit gained by the requesting spouse; (f) compliance with income tax laws; and (g) mental or physical health at the time of filing the request for relief. No single factor is determinative.

Dr. Nicole Ryke and Jamie Ryke married in 2004, and remain married. Dr. Ryke is a medical doctor with no training or experience in accounting or tax law. Mr. Ryke is a self-employed attorney who has practiced both probate law and bankruptcy law. The Rykes currently live together with their four children and share household expenses. Both Dr. Ryke and Mr. Ryke pay expenses related to their children, but Mr. Ryke pays most of their joint household expenses, including health insurance, child care, and housing costs.

Mr. Ryke has a long history of failing to pay his debts when due. Dr. Ryke became aware of her husband's financial troubles when they bought a home before marrying. While Dr. Ryke did not know the specifics of Mr. Ryke's financial past, she was aware that he had a low credit score and outstanding student loans. As a result, the Rykes had separate credit cards, and the mortgage on the home they purchased was in Dr. Ryke's name alone.

The Rykes filed joint Federal tax returns for 2004 through 2012. Each year, Mr. Ryke gathered all of the documents necessary to prepare the joint return and gave them to an accountant, who prepared the return. Once Mr. Ryke received each return, he asked Dr. Ryke to sign it; she did so, and he filed it. Mr. Ryke regularly filed for an extension of time to file, and even then the return was often filed late. Dr. Ryke had little opportunity to inspect the returns and did not examine them when she signed them.

Each year the Rykes reported a balance due on their return, but they did not submit payment of the balance. Dr. Ryke believed that her husband was paying the full tax liability when he filed each return. To her surprise, he was not. In 2011 Dr. Ryke became aware that she and her husband had outstanding joint tax liabilities. At her husband's request, she made a $53,502 payment, which was applied against their joint 2007 and 2008 tax liabilities. At that time, she believed that the payment would satisfy their outstanding tax liabilities in full. When she made the payment, she did not inquire about the amount or source of the outstanding liabilities or whether they owed any additional tax.

Dr. Ryke learned the details of the outstanding tax liabilities for 2009 and 2012 in May 2014. After consulting with an accountant, she began filing her tax returns separately from her husband, beginning with her 2013 return, and remained in full compliance with the tax rules.

Dr. Ryke asked IRS for innocent spouse relief for 2009 and 2012, but her request was denied.

Dr. Ryke met the seven threshold requirements of Section 4.01 of Revenue Procedure 2013-34, but did not qualify for streamlined relief under Section 4.02 because she and Mr. Ryke remained married. Thus, said the Tax Court, Dr. Ryke's only avenue for relief was whether she could meet a fact-specific inquiry to determine whether it would be inequitable to hold her liable for part or all of the unpaid tax on the deficiency arising from her joint returns for the years at issue.

Referencing the seven factors in §4.03 of Revenue Procedure 2013-34, the Tax Court said that the most critical inquiry was whether Dr. Ryke either knew or had reason to know that the liabilities shown on the returns would not be paid. The Tax Court found that Dr. Ryke had both knowledge that at least some part of the tax had not been paid and reason to know that the tax reported on the returns would not be paid. Before marrying, she was aware that Mr. Ryke had poor credit and was in debt, and in 2011 Dr. Ryke became aware that there were outstanding joint tax liabilities. She paid $53,502 toward those tax liabilities, but testified that she did not ask about the source of the tax debt or whether the payment would satisfy the full debt.

The Tax Court found that Dr. Ryke had reason to know that her husband was not paying the amount of tax owed each year and had actual knowledge of outstanding tax liabilities. The fact that she did not know the details of those outstanding liabilities was unfortunate, but immaterial. Dr. Ryke had reason to know the full extent of the liabilities; the fact that she lacked actual knowledge did not release her from the tax liabilities.

The Tax Court held that the remaining six factors in §4.03 were either neutral or weighed slightly in favor of relief but not enough to tip the scales. Dr. Ryke did not receive a significant benefit as a result of the underpayment of tax. Also, she came into compliance with the tax laws. Since filing separately, Dr. Ryke met both her filing requirements and her payment obligations. Although Dr. Ryke made a commendable effort to comply with the tax laws and meet her tax obligations from 2013 forward, this was simply not enough to negate her self-imposed ignorance with regard to the outstanding joint tax liabilities she owed with Mr. Ryke.

The remaining §4.03 factors were neutral. The Rykes remain married, and there was no legally binding agreement between Mr. Ryke and Dr. Ryke limiting her obligation to pay the joint liabilities. Dr. Ryke could not show that she would suffer economic hardship if relief was not granted. Finally, she offered no evidence to suggest that her mental or physical health was currently impaired or was impaired at the time of filing.

Thus, the Tax Court concluded that Dr. Ryke was not entitled to relief under §6015(f) for 2009 or 2012.

Salgado, (DC WA 3/24/2017) 119 AFTR 2d ¶ 2017-576.

A district court has held that a tax preparer's client lists and client identifying data were not trade secrets under Washington state law but that, because the preparer's clients had reasonable expectations that their personal identifying information would not become publicly available, IRS could not put the lists and data, in full detail, into the public record. Rather, the court instructed the parties to confer and submit a joint statement to the court as to what should be redacted.

IRS alleged that Jennifer Salgado, a Washington state resident, through her sole proprietor business, Jenny's Tax Services, prepared and filed hundreds of false or fraudulent federal tax returns in violation of federal law. The U.S. brought an action seeking injunctive relief-under §7407 (Action to enjoin tax return preparers) and §7408 (Actions to enjoin conduct related to tax shelters and reportable transactions)-against Salgado that would prevent her from acting as a tax return preparer for persons other than herself.

Salgado sought a protective order from the district court limiting IRS's ability to file her unredacted client lists and client personal identifying information into the public record. IRS opposed the motion and argued that Salgado did not demonstrate that good cause existed justifying a protective order in this case and that such an order would be unduly burdensome on IRS.

Federal Rules of Civil Procedure (FRCP) 5.2 provides, unless a court orders otherwise, in an electronic or paper filing with the court that contains an individual's social-security number (SSN), taxpayer-identification number (TIN), or birth date, or a financial-account number, a party or nonparty making the filing may include only: (1) the last four digits of the SSN and TIN; (2) the year of the individual's birth; and (3) the last four digits of the financial-account number.

FRCP 26(c) governs the issuance of protective orders in civil matters. Courts may issue "an order to protect a party or persons from annoyance, embarrassment, oppression, or undue burden or expense" for good cause shown. (FRCP 26(c)(1))

In Washington State, compilations of customer information may be a trade secret. (*Robbins, Geller, Rudman & Dowd, LLP v. State of Washington,* (Wash. Ct. App. 2014) 328 P.3d 905) Whether a customer list is protected as a trade secret depends on three factual inquiries: (1) whether the list is a compilation of information; (2) whether it is valuable because unknown to others; and (3) whether the owner has made reasonable attempts to keep the information secret. However, trade secret protection will not generally attach to customer lists where the information is readily ascertainable. (*Ed Nowogroski Ins., Inc. v. Rucker*, (Wash. 1999) 971 P.2d 936) And, publicly available information does not become a trade secret even if it is expensive to acquire. (*Nat'l City Bank, N.A. v. Prime Lending, Inc.,* (DC WA 2010) 737 F. Supp. 2d 1257)

Observation: Returns and return information are generally confidential and not subject to disclosure except as specifically authorized by §6103(a). Under one such exception, a return or return information may be disclosed in a Federal or State judicial or "administrative proceeding" pertaining to tax administration if one of several conditions is met. (§6103(h)(4)). Arguably, one of those conditions was met in this case. However, the parties did not make any §6103 arguments, and the court did not discuss §6103.

The court rejected Salgado's argument that, because "good cause exists to protect [her] customer information as a trade secret," the court should grant the requested protective order.

Salgado asserted that the client lists were a trade secret that was commercially valuable because they were not known to competitors or the general public. Further, she maintained that Rule 5.2-which requires parties to redact specific sensitive information such as SSNs-would not sufficiently protect the client lists at issue because they were trade secrets. Lastly, she argued that IRS did not show that the proposed protective order was unduly burdensome.

The court looked to the elements of the definition of trade secret in Washington state law. Salgado stated that she maintained copies of customer tax returns and lists of clients in compliance with federal law. The court said that her doing so created a compilation of information.

The second factor was also met. Salgado asserted that the information was commercially valuable because it was not known to competitors or the general public. Further, Salgado argued that competitors had approached her to purchase her company in the past year. She asserted that this interest from competitors was based almost entirely on the goodwill generated by the company and access to its book of business.

And, Salgado also presented information detailing the steps she took to maintain her customers' information confidentiality. The court said that the fact that she did so because she was required to do so by law was immaterial; it was undisputed that she took steps to keep her clients' information secret.

Nevertheless, the court said, whether trade secret protection attaches turns on whether the information is "readily ascertainable." Salgado proposed to designate the following information "confidential" under their proposed protective order: (1) client/spouse/dependents' name; (2) client/spouse/dependents' address; (3) client/spouse/dependents' telephone number; (4) client/spouse/dependents' SSN or TIN; (5) client banking/financial information; (6) schedule C business name, EIN, address; (7) schedule E property addresses; and (8) W-2/1099 employer/payer's name, EIN, address.

IRS asserted that that information was either publicly available or already protected from disclosure under Rule 5.2.

The court agreed with IRS's position that the information was either publicly available or protected by Rule 5.2. Accordingly, the information Salgado sought to protect was not a trade secret.

The court then ordered the parties to confer and submit a joint statement for the court's consideration and approval, regarding redactions necessary to protect the reasonable privacy concerns of Salgado' clients.

The court said that, while Rule 5.2 establishes the floor regarding the redactions parties must make when filing documents in federal court, it is well within the court's discretion to order additional protections when necessary. The court said it was concerned that Salgado' clients likely and reasonably expected that, by turning to Salgado for help in filing tax returns, their information-particularly personal identifying information-would not become publicly available.

The court said that it expected that the parties' agreement would result in public filings with all personal identifying information redacted such that a specific client could not be recognized.

Santana, TC Memo 2017-14.

The fact that an IRS error caused it to credit taxpayers' refund against their account several years late and then did not fully abate interest and penalty that the taxpayer owed with respect to two prior tax years, was not an abuse of IRS's discretion.

Interest generally begins to accrue on a Federal tax liability from the last date prescribed for payment of the tax and continues to accrue until payment is made. (§6601(a), §6622)

§6404(e)(1) provides that IRS may abate the assessment of interest on any payment of tax to the extent that any unreasonable error or delay in payment is attributable to an officer or employee of IRS being erroneous or dilatory in performing a ministerial or managerial act. For this purpose, "an error or delay shall be taken into account only if no significant aspect of such error or delay can be attributed to the taxpayer involved." (§6404(e)(1))

If IRS declines a taxpayer's request to abate interest, §6404(h) vests the Tax Court with jurisdiction to determine whether IRS's failure to abate interest was an abuse of discretion, and to order an abatement.

To prevail under §6404(e)(1), the taxpayer must (1) identify an error or delay by IRS in performing a ministerial or managerial act; (2) establish a correlation between the error or delay by IRS and a specific period for which interest should be abated; and (3) show that he or she would have paid the tax liability earlier but for the error or delay. (*Paneque*, TC Memo. 2013-48) If these factors are present, the taxpayer must also show that, in denying the taxpayer's interest abatement request, IRS abused its discretion, i.e., exercised its discretion arbitrarily, capriciously, or without sound basis in fact or law. §6404(h)(1); Lee, (1999) 113 TC 145)

§6651(a)(3) imposes a penalty in case of failure to pay any amount in respect of any tax required to be shown on a return which is not so shown, within 21 calendar days from the date of notice and demand therefor, unless it is shown that such failure is due to reasonable cause and not due to willful neglect.

A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship if he paid on the due date. In determining whether a taxpayer met this test, consideration will be given to all the facts and circumstances of the taxpayer's financial situation. (Regulation §301.6651-1(c)(1))

The Santanas timely filed their joint 2003 and 2004 Federal income tax returns on which they reported zero tax and claimed refunds (earned income credits). IRS issued the refunds.

In 2007, the Santanas filed for bankruptcy. Shortly thereafter, IRS audited the 2003 and 2004 returns and issued a notice of deficiency for both years for deficiencies that exceeded the amount of the refunds. The parties signed a stipulation in which the Santanas agreed to the deficiencies and waived restriction on the assessment and collection of their unpaid 2003 and 2004 taxes. IRS was aware of the bankruptcy petition, and an IRS employee placed a TC 520 bankruptcy freeze code on the Santanas' accounts for 2003 and 2004.

In 2009, the Santanas moved for dismissal of their bankruptcy case, and the bankruptcy court entered a dismissal order on July 16, 2009. IRS, however, failed to lift the TC 520 bankruptcy freeze designation in its computer system with respect to the Santanas. Despite the TC 520 bankruptcy designation in the Santanas' administrative file, on July 30, 2009, IRS mailed the Santanas a Letter 3172, Notice of Federal Tax Lien Filing and Your Right to a Hearing Under IRC 6320, with respect to their unpaid 2003 and 2004 income tax liabilities. The Santanas acknowledged that they received the notice of lien filing.

The Santanas timely filed their 2009, 2010, 2011, 2012, and 2013 Federal income tax returns, on which they claimed refunds. Because of the TC 520 bankruptcy freeze code in the Santanas' administrative file, the refunds were frozen. The Santanas did not inquire as to the whereabouts of, and made no effort to receive, their refunds until May 21, 2013, when they contacted IRS inquiring as to the status of their 2012 refund. As a result of the Santanas' inquiry, IRS discovered the TC 520 bankruptcy freeze code placed on the Santanas' account; the code was corrected, and the freeze was lifted.

IRS applied the amounts of refunds due the Santanas from their overpayments of 2009-2013 taxes against the Santanas' outstanding 2003 and 2004 tax liabilities. Although the actual application of the refunds due the Santanas was not made until 2013, IRS treated the refunds as if made earlier, i.e., on the dates the Santanas' respective tax returns were filed-April 15 of the appropriate year. By the application of the refunds on the tax return filing dates, the amount of interest payable by the Santanas to IRS was reduced. Thus, said the Court, IRS gave the Santanas the maximum possible benefit. Still, these reductions were insufficient to eliminate the Santanas' outstanding liabilities.

The Santanas then sought and received a Collection Due Process hearing in which they requested, among other things, complete abatement of the underpayment interest and the §6651(a)(3) penalty. The Santanas asserted that they could not fully pay their income tax liabilities. However, the Santanas did not provide information with regard to their current financial situation or their ability to pay.

As a result of the hearing, IRS issued a notice of determination under which 50% of the interest accrued from March 9, 2009 (the date IRS assessed the deficiencies in tax and penalties), until April 10, 2014 (the date of the hearing), was abated. With respect to the Santanas' request that the §6651(a)(3) penalty be eliminated, IRS agreed to eliminate it with respect to the Santanas' underpayment of tax but did not agree to eliminate it with respect to the earned income credits because the Santanas had received cash refunds for those amounts.

The Santanas brought suit to have the entire underpayment interest and the entire §6651(a)(3) penalty abated.

The Court rejected the Santanas' argument for full interest abatement and agreed with IRS's limited abatement.

The Court noted, citing H. Rept. 99-426 at 844 (1985), that Congress intended for IRS to abate interest "where failure to abate interest would be widely perceived as grossly unfair" and that it did not intend that abatement "be used routinely to avoid payment of interest."

IRS miscoded the Santanas' account, a ministerial error. The erroneous bankruptcy code froze the Santanas' claimed refunds and prevented IRS from properly communicating with the Santanas regarding their claimed refunds until May 21, 2013, thus satisfying the first two requirements of §6404(e).

The Santanas argued that they met the third requirement in that they were waiting for IRS to communicate with them regarding their unpaid income tax liabilities before making payments, a communication that never occurred until IRS corrected the coding error after the Santanas enquired about their missing 2012 refund in 2013. But in fact, IRS did communicate with the Santanas; specifically, IRS mailed a notice and demand letter to the Santanas on March 9, 2009, and a notice of lien filing on July 30, 2009. The Santanas acknowledged that they received the notice of lien filing, which should have alerted them that IRS had commenced collection activities against them and their property. The notice of lien filing cannot be seen as anything other than a communication regarding the Santanas' unpaid income tax liabilities.

As a result, the Court said that the Santanas did not establish that they would have paid the tax liabilities earlier but for the error or delay and that it could not conclude that IRS's refusal to abate all of the accrued interest was arbitrary, capricious, or without sound basis in fact or law (i.e., an abuse of discretion).

As to the §6651(a)(3) penalty calculation, the Court concluded that, because the Santanas did not provide the Court with their financial information, it could not determine whether they exercised the ordinary care and prudence that they had to exercise to demonstrate reasonable cause. It noted that, despite the Santanas' failure to provide the IRS Settlement Officer with the necessary information, she reduced, but did not eliminate, the §6651(a)(3) penalty. The Court stated, "We will not disturb her determination."

Santander Holdings USA, Inc. v. U.S., (CA 1 12/16/2016) 118 AFTR 2d 2016-6914, cert denied 6/26/2017.

The Supreme Court had declined to review a decision of the Court of Appeals for the First Circuit, which reversed a district court, and held that the "trust" component of a Structured Trust Advantaged Repackaged Securities (STARS) transaction lacked economic substance. The First Circuit had found that the trust transaction, which involved the participating bank transferring assets to a disregarded foreign trust and claiming credits for foreign taxes paid, had no legitimate business purpose and, absent the generation of foreign tax credits, provided no objective economic benefit.

To determine whether a transaction has economic substance, courts usually make a two-pronged factual inquiry:

1. Was the taxpayer motivated by no business purpose (other than getting tax benefits) in entering into the transaction? (Subjective test)

2. Did the transaction have objective economic substance, i.e., was there a reasonable possibility of a profit? (Objective test) *(Frank Lyon Co v. U.S.,* (S Ct 1978) 41 AFTR 2d 78-1142)

The economic substance doctrine allows the government to look beyond technical compliance with the Code to ascertain the real nature of the transaction at issue.

The Circuits have differed in their application of the two-prong test. The Fourth Circuit requires only that a transaction have either a subjective business purpose or objective economic substance in order to be respected (the disjunctive test). (*Rice's Toyota World Inc. v. Commissioner,* (CA 4 1985) 55 AFTR 2d 85-580) On the other hand, the Eleventh Circuit (*United Parcel Service of America Inc.,* (CA 11 2001) 87 AFTR 2d 2001-2565), the *Federal Circuit (Coltec Industries Inc. v. U.S.,* (Ct Fed Cl 2004) 94 AFTR 2d 2004-6708), the Sixth Circuit (*Dow Chemical CO v. U.S.,* (CA 6 2006) 97 AFTR 2d 2006-671), and the Fifth Circuit (*Klamath Strategic Investment Fund v. U.S.,* (CA 5 2009) 103 AFTR 2d 2009-2220) require both (the conjunctive test).

Observation: For transactions entered into after March. 30, 2010-i.e., after the time period involved in this case-the *Health Care and Education Reconciliation Act* (P.L. 111-152, 3/30/2010) added §7701(o). It provides that a transaction is treated as having economic substance under a conjunctive two-prong test only if, apart from Federal income tax effects, both: (1) the transaction changes the taxpayer's economic position in a meaningful way; and (2) the taxpayer has a substantial purpose for entering into the transaction. That is, the taxpayer's non-Federal-income-tax purpose for entering into a transaction must be "substantial."

Both the U.S. and foreign countries may tax the foreign source income of U.S. taxpayers. To ease this double taxation burden, the Code permits most U.S. taxpayers who pay income taxes to a foreign country to either deduct the taxes from gross income for U.S. purposes or credit them dollar for dollar against their U.S. income tax liability on foreign source income. (§901)

Legislative history provides that the foreign tax credit "was originally designed to produce uniformity of tax burden among United States taxpayers, irrespective of whether they were engaged in business in the United States or business abroad."

The Second Circuit and the Federal Circuit have held that banks cannot claim foreign tax credits from STARS transaction similar to the one at issue here because the transactions lacked economic substance. (*Bank of New York Mellon Corporation v. Commissioner,* (CA 2 2015) 116 AFTR 2d 2015-6014, cert denied 3/7/2016; *Salem Financial, Inc. v. U.S.,* (CA Fed Cir 2015) 115 AFTR 2d 2015-1835, cert denied 3/7/2016). In addition, a district court in the Eighth Circuit found that the trust structure, which generated the disputed foreign-tax credits in a similar STARS transaction, lacked economic substance. (*Wells Fargo & Co. v. U.S.,* (DC MN 2015) 116 AFTR 2d 2015-6738)

Sovereign Bancorp, Inc. (Sovereign), which was later known as Santander Holdings USA, Inc., engaged in a STARS transaction promoted by the U.K.-chartered Barclays Bank PLC (Barclays). As described by the court, the transaction featured Barclays receiving substantial benefits under U.K. tax laws and lending funds to U.S. banks at a lower cost than otherwise might be available to them.

As part of the STARS transaction, Sovereign created a trust to which it contributed $6.7 billion of income-generating assets. The trustee of the trust was made a U.K. resident so that the trust's income was subject to U.K. income tax at a 22% rate. The trust income was also subject to U.S. income tax and was attributed to Sovereign. Sovereign paid the U.K. taxes and then claimed a foreign tax credit under §901 in calculating its U.S. income tax liability. This component of the transaction was referred to by the court as the "trust transaction."

Over the course of a year, Barclays acquired a $1.15 billion interest in the trust, which it was required to sell back to Sovereign, for $1.15 billion, at the end of the transaction. Sovereign treated the $1.15 billion as a loan and claimed interest deductions on it. The trust engaged in certain actions that generated a U.K. tax benefit for Barclays in exchange for which Barclays made a monthly payment (the "Barclays payment") equal to half of the amount of U.K. taxes paid by Sovereign on the trust's income that Sovereign netted against its interest obligation on the purported loan (the "loan transaction").

IRS disallowed foreign tax credits claimed by Sovereign for 2003, 2004, and 2005. IRS claimed that the Barclays payment was effectively a rebate of the U.K. taxes paid, in that it relieved Sovereign of half the burden of its U.K. taxes, and further claimed that the STARS transaction as a whole was a sham without economic substance. Sovereign sued to recover $234 million in federal income taxes, penalties, and interest.

In 2013, a Massachusetts district court granted Sovereign partial summary judgment that the Barclays payment should be accounted for as revenue to Sovereign in assessing whether Sovereign had a reasonable prospect of profit in the STARS transaction. For more details on this decision.

Sovereign then moved for summary judgment on its claims for refunds of taxes paid in 2003, 2004, and 2005, as well as deficiency interest assessed by IRS. The district court again sided with Sovereign, upholding the legitimacy of both the trust and loan transactions and allowing Sovereign to claim interest deductions and foreign tax credits for the U.K. taxes paid. The court also found that, since the credits and interest deductions were properly claimed, Sovereign should not be assessed penalties. For more details.

The First Circuit found that the district court committed reversible error and that the government was entitled to summary judgment as to the economic substance of the trust transaction.

The Court noted that it did not matter how the Barclays payment was characterized (i.e., rebate or income) because, regardless, the trust transaction itself did not have a reasonable prospect of creating a profit without considering the foreign tax credits and thus is not a transaction for which Congress intended to give such a benefit. The First Circuit found that the transaction was shaped solely by tax avoidance features, lacked a bona fide business purpose, and was "profitless," in that the purported profit from the Barclays payment was more than negated by the costs of the transaction. The entire function of the trust transaction was exposure to U.K. taxation in order to generate foreign tax credits, which does not "advance the Tax Code's interest in providing foreign tax credits in order to encourage business abroad or in avoiding double taxation."

The First Circuit also found it telling that the trust transaction lacked any real economic risk, as Barclays and Sovereign both had contractual remedies and took other steps to minimize such risk. It also noted that Sovereign's U.K. tax liability was artificially generated through a series of "circular cash flows" through the trust, which, as noted above, existed just to generate the desired tax effect.

Accordingly, the First Circuit reversed the district court's decision as to the economic substance of the trust transaction and the foreign tax credits claimed.

On June 26, 2017, the Supreme Court refused to review the First Circuit's decision. Accordingly, that decision is now final.

Schaffran, TC Memo 2017-35.

The father of a business's co-manager was not a "responsible person" for purposes of the §6672 trust fund recovery penalty on the strength of signing a few checks. The father lacked sufficient control over the business to avoid nonpayment of its payroll taxes, was not an owner, director or employee, and was not even an official signatory or the business's back accounts.

§6672 imposes a responsible person penalty (aka trust fund recovery penalty) on any person who: (1) is responsible for collecting, accounting for, and paying over payroll taxes; and (2) willfully fails to perform this responsibility. The amount of the penalty is equal to the amount of the tax that was not collected and paid.

In determining whether an individual is a responsible person, courts consider factors including whether the taxpayer served as an officer of the corporation or a member of its board of directors, owned a substantial amount of stock in the company, participated in day-to-day management of the company, determined which creditors to pay and when to pay them, had the ability to hire and fire employees, or possessed check writing authority. Not every factor must be present; instead, a court must consider the totality of the circumstances to determine whether the individual in question had the effective power to pay the taxes owed. There can be more than one responsible person in a business.

Willfulness for purposes of §6672 includes a voluntary, conscious and intentional act to prefer other creditors over the U.S. Thus, if a responsible person knows that withholding taxes are delinquent, and uses corporate funds to pay other expenses, such failure to pay withholding taxes is deemed "willful." (*Mazo v. U.S.,* (CA 5 1979) 43 AFTR 2d 79-853, *Thibodeau v. U.S.,* (CA 11 1987) 60 AFTR 2d 87-5763)

In March of 2006, Paul Roberts organized the Restaurant Group of Destin, LLC (Restaurant Group), which opened Sunset Charlie's, a beachside restaurant in Miramar Beach, Florida. He was Restaurant Group's owner and managing member and, along with Carlos Shaffran, Roberts oversaw Sunset Charlie's day-to-day operations, including payroll-related matters. Restaurant Group maintained three bank accounts at Whitney National Bank: an operating account, a "payroll" account, and a "tax" account. Mr. Roberts and Carlos were authorized signatories on all three accounts and regularly signed checks drawn on them.

During Sunset Charlie's existence, Charles Shaffran, Carlos's father, visited the restaurant two or three times per week for several hours. While there Charles did errands for Mr. Roberts and Carlos. However, under Mr. Roberts' and Carlos' direction, Charles occasionally trained bartenders, received deliveries, and provided suppliers with checks signed by Mr. Roberts or Carlos. It's not clear from the facts whether Charles was paid for the services he provided, but it's clear he was not a salaried employee.

Sometimes Charles wrote out checks for Carlos to sign because Charles had more legible handwriting. Some of these checks were written to Charles or Charles's wife in partial repayment of a $6,500 loan that she had extended to Restaurant Group. In August of 2006, Mr. Roberts was out of town. Between August 3 and 14, 2006, Charles signed four checks drawn on Restaurant Group's operating account. He signed two of these checks to pay suppliers for deliveries that arrived when neither Mr. Roberts nor Carlos was available. Charles signed the other two checks, which were payable to himself and his wife, in partial repayment of her loan, at the behest of Mr. Roberts. Whitney National Bank honored all four checks even though Charles was not an authorized signatory. Charles did not sign any other checks on behalf of Restaurant Group or otherwise determine how it spent its available funds.

Restaurant Group struggled financially and did not remit employment taxes to IRS for the third quarter of 2006, all four quarters of 2007, or the fourth quarter of 2008. It also fell behind on payments to its suppliers and its landlord. In 2008, Restaurant Group was evicted from the location where it had operated Sunset Charlie's. It ceased doing business that year.

IRS issued a series of trust fund recovery penalty letters in connection with Restaurant Group's nonpayment of employment taxes, including one to Charles. IRS's revenue agent charged with the investigation was under the mistaken impression that Charles regularly signed Restaurant Group's checks.

IRS argued that Charles was a responsible person because he acted as a "de facto officer" by signing four checks and writing out several others for Carlos' signature. Charles argued that he was not a responsible person because he was not an owner or manager of Restaurant Group and lacked authority to sign checks or determine the priority of payment to its creditors.

Taxpayer not a responsible person. The Tax Court found that the preponderance of the evidence established that Charles lacked sufficient control over Restaurant Group's affairs to avoid the nonpayment of its employment taxes during the tax periods in question. He was not an officer, director, employee or owner of Restaurant Group at any time. He was never an authorized signatory on Restaurant Group's bank accounts.

It also was clear from Charles's credible testimony and the administrative record that he: (1) did not have the authority to hire and fire Restaurant Group's employees; (2) had no duty to, and did not, review or reconcile Restaurant Group's bank statements; and (3) had no control over disbursements and decisions regarding Restaurant Group's bank accounts, including the payroll account. Also, there was no evidence that Charles had any involvement in the preparation or filing of Restaurant Group's employment tax returns or the payment of its employment taxes.

The Tax Court was not persuaded by IRS's argument that Charles was a responsible person because he signed and/or wrote out a small number of Restaurant Group's checks. The four checks bearing Charles's signature were all signed in the span of two weeks in August of 2006 when Mr. Roberts was out of town (and before four of the five tax periods in question). Of these four checks (less than 1% of the checks Restaurant Group issued during the third quarter of 2006), two were written and signed only after Mr. Roberts had told Charles to do so. The other two were signed in unusual circumstances where Charles was the only person available to take delivery of vendor orders. The Tax Court said that such limited check signing activity did not support a finding that Charles had sufficient control over Restaurant Group's affairs to avert the nonpayment of its employment taxes.

Regarding the checks written by Charles but signed by his son, Carlos, the Tax Court said this practice only confirmed that Charles did not have authority to disburse Restaurant Group's funds. To be sure, the exercise of check signing authority was a significant factor in determining whether someone has authority to choose which creditors to pay. In contrast, the preparation of checks for another's signature did not connote such authority. Accordingly, the Tax Court concluded that Charles was not a responsible person for §6672 purposes.

Sexton v. Hawkins (DC NV 3/17/2017) 119 AFTR 2d ¶ 2017-552.

A district court, citing the 2014 DC Circuit holding in Loving that limited IRS regulation of tax return preparers, has rejected IRS arguments that: a) the federal statute that regulates tax professionals extends to tax professionals who both are suspended from practice due to misconduct and offer services within the scope of the statute; and b) that statute extends to tax professionals who offer written tax advice, regardless of whether they represent clients in a tax controversy before IRS.

Under 31 U.S.C. §330 ("Section 330"), the Treasury Secretary has authority to regulate the practice of representatives of persons before the Treasury Department. Since IRS is a bureau of the Treasury Department (26 C.F.R. §601.101(a)), the statute also covers practice before IRS. Thus, the statute allows IRS to regulate "representatives" who "practice" before it.

Circular 230(Regulations Governing Practice before the Internal Revenue Service), 31 C.F.R. Subtitle A, Part 10, implements the authority Congress gave the Secretary of the Treasury in 31 U.S.C. §330 to regulate practice before IRS. It "contains rules governing the recognition of attorneys, certified public accountants, enrolled agents, enrolled retirement plan agents, registered tax return preparers, and other persons representing taxpayers before the Internal Revenue Service."(31 C.F.R. §10.0)

Section 330(e) provides "Nothing in this section or in any other provision of law shall be construed to limit the authority of the Secretary of the Treasury to impose standards applicable to the rendering of written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement, which is of a type which the Secretary determines as having a potential for tax avoidance or evasion." 31 C.F.R. §10.2(a)(4) provides that such rendering is "practice before the Internal Revenue Service."

When a proper and lawful request is made by a duly authorized officer or employee of IRS concerning an inquiry into an alleged violation of Circular 230, a representative must provide any information the representative has concerning the alleged violation and testify regarding this information in any proceeding instituted under Circular 230, unless the representative believes in good faith and on reasonable grounds that the information is privileged. (31 C.F.R. §10.20(a)(3))

In June of 2011, IRS issued final regulations that modified Circular 230 to provide for competency testing, continuing professional education, and ethical standards for a new class of representative called a registered tax return preparer.

In *Loving,* (DC DC 01/18/2013) 111 AFTR 2d 2013-589, a district court concluded that IRS lacked statutory authority to promulgate or enforce those final regulations.

The DC Circuit, in *Loving,* (CA DC 02/11/2014) 113 AFTR 2d 2014-867, affirmed the district court's ruling. It cited several reasons, including: a) tax return preparers are not representatives; and b) tax return preparation does not involve practice before IRS because it does not involve an adversarial proceeding, as envisioned by Congress.

Courts employ a 4-factor test to determine whether to issue a permanent injunction, examining whether (1) the plaintiff has suffered an irreparable injury; (2) "remedies available at law, such as monetary damages, are inadequate to compensate for that injury";(3) "considering the balance of hardships between the plaintiff and IRS, a remedy in equity is warranted"; and (4) a permanent injunction would not disserve the public interest. (*eBay Inc. v. MercExchange,* L.L.C., (S Ct 2006) 547 U.S. 388)

After his pleading guilty to mail fraud and money laundering, Sexton, who was previously a lawyer, was disbarred and suspended from practicing before IRS by the IRS Office of Professional Responsibility(OPR).

Prior to and during his suspension, Sexton offered professional tax services as president of Esquire Group. Sexton assisted with the preparation of tax returns for individual clients of Esquire. Sexton assisted his client, Ms. Kern, in preparing her tax returns and offered to send her a written memorandum analyzing her options regarding her business' tax obligations. Before accepting Sexton's offer, Kern found out about Sexton's disbarment, fired him, and submitted a complaint to OPR.

Following Kern's complaint, OPR initiated an investigation of whether Sexton was violating his suspension from practicing before IRS. OPR sent a request to Sexton, as president of Esquire, for information related to an investigation of alleged unauthorized practice by Sexton during his suspension. OPR requested a wide range of information from Sexton, alleging that this information was required under 31 C.F.R. §10.20(a)(3). This included a request for detailed information on Sexton's educational background; documents related to the incorporation of Esquire Group and its entity structure; and a list of all members, employees, and independent contractors of Esquire Group.

Sexton petitioned the court for the following relief:

1. A declaratory judgment by the court that Sexton was not a representative as defined by federal law and that IRS lacked statutory authority to enact, promulgate or enforce demands or authority over him and/or his employer Esquire as a result of Sexton's activities.

2. A declaratory judgment by the court that IRS is prohibited from regulating the providing of tax advice generally, except as specifically provided by statute and conferred upon them by Congress.

3. A permanent injunction prohibiting IRS from seeking to enforce Section 10.20 of Circular 230 against him.

The Court, noting its adoption of the legal analysis and reasoning in Loving, granted Sexton all of the relief that he sought. In so doing, it noted:

a. Suspended representatives are not covered under Section 330. IRS offered several arguments for its general proposition that Section 330 creates an inherent jurisdiction or authority over former representatives before IRS. The court rejected all of those arguments.

First, IRS argued Section 330 extends to individuals who have previously been authorized to practice before IRS but whose authority to practice before IRS has been suspended but not completely terminated. IRS conceded that neither Section 330, nor the regulations promulgated thereunder in Circular 230, expressly provide that OPR's regulatory authority extends to persons who are suspended from practice before IRS. IRS then cited to a general principle that a professional licensing or disciplinary body retains authority over a suspended member to investigate and act on alleged violations of the suspension or violations of law or rules of professional conduct while suspended.

However, IRS's only authority for this proposition was a non-binding state court case, *Kirven v. Secretary of the Board of Commissioners on Grievances and Discipline,* (SC 1978) 246 S.E.2d 857, which provided "...based on his assumption that an attorney who has been indefinitely suspended is not an attorney and thus is not subject to this Court's disciplinary authority...[t]his assumption is false." The court here said that it was unaware of any binding authority or federal case law holding that a disbarred lawyer is the equivalent of a suspended representative under Section 330. And, it noted that Kirven was not even on point. Kirven involved the jurisdiction of the state agency's authority to investigate an allegation of misconduct and not whether the particular individual was subject to the agency's authority such that he would be legally required to respond to a complaint or request for documents.

And IRS argued that because Section 330(b) gives IRS the power to suspend an individual from practice, the reasonable presumption is that Congress intended for oversight to continue after suspension, given that the statute also includes the more severe sanction of disbarment, as well as the alternative sanction of a monetary penalty, either or both of which are potentially available in the case of representatives who essentially disregard a censure or suspension.

The court said that this presumption, however, does not logically follow from the statute. The fact that the statute allows for varying levels of discipline supports only the inference that IRS has the authority to impose different sanctions based upon the severity of the violations of the representative. It does not support a presumption or inference that IRS would have the authority to regulate the provision of certain types of professional services, such as tax preparation, which it would otherwise not be able to regulate but for the fact that the offeror of such services had previously been a representative before IRS. An individual does not subject himself to indefinite and undefined oversight by IRS based upon suspension. Indeed, such a rule would result in suspension becoming potentially a more severe penalty than disbarment. In any event, the court said, it did not find that suspension, as argued by IRS, allows for continued or indefinite regulation of previous representatives in their subsequent employment as tax preparers.

a. Section 330 does not extend to Sexton merely because he offered written advice. The court then found Section 330 does not extend to tax professionals offering written advice unless they represent clients in a tax controversy before IRS.

IRS first cited two pre-Loving decisions by administrative law judges(ALJs). In one such case, an ALJ found that Section 330(e) applies to representatives that did not represent persons in cases before IRS within the meaning of Loving. The court found that these ALJ decisions were not persuasive or controlling.

IRS also attempted to distinguish Loving from the current case, arguing that Loving did not discuss Section 330(e) specifically, but rather addressed different subsections within Section 330. IRS argued that the Loving plaintiffs were in the business of preparing tax returns, and they were not in the business of authoring written tax opinions for corporate clients or high net-worth individuals. But the court found Loving's interpretation of Section 330 to be applicable in this case. The Loving court's extensive analysis of Section 330 and its statutory history and context supported the current court's reading of the statute.

However, the court said, even assuming that Loving did not impact Section 330(e), it found that Section 330(e) did not apply to the facts in this case. IRS conceded Sexton was permitted to prepare taxes under the scope of his suspension, but argued that he could not offer written advice regardless of whether there was a tax controversy before IRS under Section 330(e). The Court did not find that the plain language of Section 330(e) supports this interpretation. At most, Section 330(e) allows IRS to impose standards to the rendering of such advice; it does not provide a mechanism to sanction such advice, nor the offering of such advice. This is in stark contrast to the following language in Section 330(c): "after notice and opportunity for a proceeding, the Secretary may suspend or disbar from practice before the Department, or censure, a representative...The Secretary may impose a monetary penalty on any representative described in the preceding sentence."

a. Sexton met criteria for a permanent injunction. The court concluded that Sexton satisfied all four prongs of the permanent injunction test. While Sexton's injuries were largely financial, which alone would not support a finding of irreparable harm, Sexton also argued that IRS's actions, if they were to continue, would result in the effective termination of his vocation. As in Loving, the court found that this effective termination constitutes irreparable injury. The Court further found that Sexton lacked an adequate remedy at law regarding his ability to challenge the OPR's actions. The Court also concluded that the balance of hardships tipped in Sexton's favor, as IRS's actions were not permissible under Section 330 and he would suffer financial loss.

> Finally, a permanent injunction would serve the public interest because of the inapplicability of Section 330 to tax preparers such as Sexton.

Shiner v. Turnoy, (CA 7 3/16/2017) 119 AFTR 2d ¶ 2017-542.

The Court of Appeals for the Seventh Circuit, reversing a district court, has held that, where there was a dispute between a payor and a payee as to the amount the payor owed the payee, the payor wrote a check to the payee for the amount the former believed he owed, the check provided that cashing it would release the payor of any future obligation to the payee, and the payor submitted a Form 1099 for the amount of the check, the payor did not willfully file a fraudulent information return despite the fact that the payee did not cash the check.

§7434(a) provides that, if any person willfully files a fraudulent information return with respect to payments purported to be made to any other person, such other person may bring a civil action for damages against the person so filing such return.

Individuals who do not accept payment may still be in "constructive receipt" of the income. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. (Regulation §1.451-2(a))

Under Regulation §1.6041-1(h), "For purposes of a return of information, an amount is deemed to have been paid when it is credited or set apart to a person without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made."

Shiner and Turnoy-both licensed producers of life insurance products-entered into an agreement that Turnoy would pay Shiner one half of the commissions generated by the procurement of two life insurance policies. Turnoy said that he had received $298,000 in such commissions, but over weeks of increasingly heated correspondence, Shiner insisted that the actual amount of commissions (and consequently his share) was significantly higher.

Turnoy responded on December 17, 2012 by sending a check to Shiner for $149,000, half of the $298,000 that Turnoy maintained he had received in commissions-a check that read on the reverse side (at the place for endorsement) that "endorsement constitutes full & absolute release/hold-harmless by Shiner &/or all interested persons/parties." Included with the check was a letter that said that the $149,000 would be reported on a Form 1099.

On the next day, Shiner filed a lawsuit charging Turnoy with breach of contract. Turnoy was not served until January 30, 2013, and Shiner neither deposited nor negotiated the check. With Shiner's action against Turnoy then pending, Shiner ultimately returned the check to Turnoy in August 2013.

Turnoy told his accountant Michael Weisberg that he had sent Shiner a check for $149,0000 in late December 2012, but he did not inform Weisberg that Shiner disputed the amount of payment or that the check contained a restrictive endorsement. Weisberg advised Turnoy that, pursuant to the Code, he was required to file a Form 1099 as to Shiner no later than January 31, 2013. At Turnoy's direction, Weisberg then prepared and filed a Form 1099, and he sent a copy to Shiner on January 25, 2013.

Shiner brought a district court action in August 2013 charging that: (1) the Form 1099 was false because Shiner never accepted the check; and (2) Turnoy violated §7434(a) by willfully filing an inaccurate information return.

The district court held that Turnoy willfully filed a fraudulent return, in violation of §7434(a). (*Shiner v. Turnoy*, (DC IL 2014) 114 AFTR 2d 2014-5179)

The court looked to Bones, (1944) 4 TC 415, which it concluded was on all fours with this case. It said that, normally, creditors do not have the right to refuse or delay their acceptance of a check for tax purposes, and so they are in constructive receipt from the time they receive the check. When there is a dispute over the underlying debt for which a check purports to be in full satisfaction, however, the placement of a restrictive endorsement on that check imposes a condition upon its acceptance and gives the creditor a legal right to reject the condition by refusing the check. In such situations, receiving a check with a restrictive endorsement does not constitute constructive receipt, and no payment will be considered as having been made unless and until the check is actually accepted.

When Turnoy included a restrictive endorsement on his check to Shiner, he transformed it from a simple payment into an offer of payment subject to a condition. That being so, Turnoy would not actually have made the payment unless Shiner had affirmatively accepted that offer by negotiating the check-which he did not do.

And, the district court concluded that Turnoy exhibited willfulness in filing the fraudulent Form 1099. It said that "willfully" in this context means a voluntary, intentional violation of a legal duty and that Turnoy intentionally attempted to deceive IRS by filing the Form 1099 without believing that it was true.

The Circuit Court reversed the district court and remanded the case with directions to grant summary judgment for Turnoy.

The Court reasoned that Turnoy had filed the Form 1099 more than a month after sending the check to Shiner, and during that time Shiner had neither asked Turnoy for a new check-a check without a restrictive endorsement-nor otherwise communicated to Turnoy a rejection of the check. Shiner's inaction gave Turnoy a solid basis for believing that Shiner had accepted the check Turnoy had sent him despite the restrictive endorsement, so Turnoy's filing of the Form 1099 "could not have been willfully...fraudulent," as required by §7434(a).

In re: Estate of Frederick Alan Simmons, (DC IN 07/31/2017) 120 AFTR 2d ¶ 2017-5109.

A district court, adopting a Magistrate Judge's recommendation and relying on the Federal Tax Lien Act (§6321 - §6323), found that IRS's liens over property that had been held by the decedent had priority over the payment of the reasonable administrative expenses of the estate.

§6321 imposes a lien on all property and property rights of a taxpayer liable for taxes after a demand for the payment of the taxes has been made and the taxpayer fails to pay those taxes. The lien arises at the time assessment is made and continues until the liability is satisfied or becomes unenforceable by lapse of time. (§6322)

If IRS files the appropriate notice of the federal tax liens, its lien prevails over all other interests, except for purchasers, holders of security interests, mechanics lienors, and judgment lien creditors whose interests are choate (i.e., completed or perfected) at the time that the notice of federal tax lien is filed. (§6323, *Sgro v. U.S.,* (CA 1979) 45 AFTR 2d 80-361)

The Federal Priority Statute (31 USC 3713) directs that the government be paid first when the estate of a deceased debtor has insufficient assets to pay all of its debts. Personal liability may be imposed upon a fiduciary of an estate who fails to honor a priority claim of the government. (31 USC 3713(b))

Indiana Code §29-1-10-13 states in pertinent part that: "The personal representative, when no compensation is provided in the will..., shall be allowed such compensation for his services as the court shall deem just and reasonable.... An attorney performing services for the estate at the instance of the personal representative shall have such compensation therefor out of the estate as the court shall deem just and reasonable."

Frederick Alan Simmons died on June 5, 2014. Raelinn M. Spiekhout, the surviving spouse and the estate's personal representative, probated the estate. The principal asset of the estate was real property located in Indiana (the Property). Once the Estate was opened in state court, a number of claims were filed against the Estate, including a $591,406 claim by IRS for unpaid federal income taxes and trust fund recovery penalties. Spiekhout did not serve notice on the U.S. in accordance with 28 USC 2410(b) so as to trigger the 30-day period allowing removal of the proceeding to a federal court.

The state court approved the sale of the Property on April 16, 2015. On May 11, 2015, Spiekhout filed a petition to close the Estate as insolvent, showing that the Estate anticipated having total distributable assets of only $266,873, contrasted against the $1,812,622 in claims made against the Estate. This petition was also not served on the government so as to trigger the 30-day removal time.

On July 10, 2015, the state court issued an order closing the Estate as insolvent and ordered distribution of the proceeds from the sale of the Property. The distribution listed the federal tax lien as seventh in priority among the creditors.

Shortly thereafter, the U.S. removed the state court action to the district court, challenging the state court's disposition of its tax lien and seeking to reduce Simmons' unpaid federal tax liabilities to judgment, enforce federal tax liens against the Property, and determine the priority of liens encumbering the Estate's property.

On May 27, 2016, the district court issued an order authorizing the sale of the Property for $275,000. The district court acknowledged receipt of $245,766, representing the net proceeds of the sale of the Property after payment of receiver's commission and the costs of sale.

On September 8, 2016, Spiekhout filed a motion for a hearing to determine claim priorities.

The district judge referred the matter to a Magistrate Judge who issued a report and recommendation which found that the government had a priority interest for the proceeds from the sale of the Property.

Spiekhout argued that the Magistrate Judge erred in his findings of fact by failing to acknowledge the extensive services that she provided and funds she advanced for maintenance and preservation of the Property. Spiekhout contended that without her efforts, the Property would not have been sold. She also objected to the Magistrate Judge's conclusions of law because his report and recommendation relied on the Federal Tax Lien Act, rather than the Federal Priority Statute, 31 USC 3713. Further, she asserted that as personal representative, she and her counsel were entitled to just and reasonable compensation for their services under Indiana Code §29-1-10-13.

On the other hand, the government noted that Spiekhout did not challenge or dispute the Magistrate Judge's findings of fact, but argued only that the Magistrate Judge erred in not including additional facts-that she provided extensive services and funds for the preservation of the Property. The government contended that the exclusion of the additional facts requested by Spiekhout did not amount to error because those facts were irrelevant to the determination of priority. There was no dispute that the government properly filed notice of its federal tax liens. As such, the government argued its liens prevailed over Spiekhout's interest because she was not a purchaser, holder of security interest, mechanics lienor, or judgment lien creditor.

The district court, agreeing with IRS, concluded that the Magistrate Judge did not err when omitting additional facts related to Spiekhout's efforts in preserving the Property, because these facts were irrelevant as to the issue before the court-the issue of priority.

The district court, adopting the Magistrate Judge's recommendation, concluded that the Federal Tax Lien Act, rather than the Federal Priority Statute, governed whether IRS's tax liens had preference to the proceeds from the Property. The district court looked to the Supreme Court's decision in *U.S. v. Estate of Romani,* (S Ct 1998) 81 AFTR 2d 98-1729, holding the Federal "Tax Lien Act, rather than federal priority statute, under which a claim of United States Government "shall be paid first" when debtor's estate cannot pay all of its debts, is governing statute when Government claims preference in insolvent estate of delinquent taxpayer." Accordingly, because Spiekhout's interest did not fall under any of the exceptions listed in §6323 - purchaser, holder of security interest, mechanics lienor, or judgment lien creditor-the government's tax liens had priority.

The district court also looked to *Estate of Friedman v. Cadle Co.,* (DC CT 2009) 2009 WL 7271206, where that court stated that "there is no indication that Congress intended to subordinate a federal tax lien to the type of claim asserted by the Estate. If Congress had wanted funeral and administrative expenses to prime an antecedent recorded federal tax lien, it could have done so."

The district court rejected Spiekhout's contention that no reasonable personal representative or counsel would provide services under such an imposition. The district court noted that Spiekhout's policy argument was addressed and remedied by the procedures set out in the Internal Revenue Manual (IRM). Under IRM 5.5.2.4(3), IRS "may in its discretion not assert priority over reasonable administrative expenses of the estate." Here, IRS made clear that, if documentation is provided evidencing payments made by Spiekhout to maintain the Property, it will allow Spiekhout's unreimbursed expenses to be paid ahead of the federal tax liens.

Smith, (2017) 148 TC No. 21.

In a case of first impression, the "amounts in dispute" in §7623(b)(5)(B) (i.e., the $2 million threshold before IRS is required to pay a whistleblower award) is the total amount of the liability that IRS proposed with respect to a taxpayer's examination that was begun using the information provided by a whistleblower, and was not limited to the part of the "collected proceeds" attributable to the whistleblower's information or specific allegations.

Under §7623(a), IRS has discretionary authority to pay awards to informants (i.e., whistleblowers) in the sums it considers necessary for the detection of tax underpayments, or for the detection, trial, and punishment of tax law violators.

Under §7623(b), individuals are entitled to receive an award of 15% to 30% (or lower amounts in cases of less substantial contribution) of the collected proceeds resulting from an action based on information provided by the whistleblower in any action: [Emphasis added] (§7623(b)(5))

1. against any taxpayer, but in the case of any individual taxpayer, only if such individual's gross income exceeds $200,000 for any tax year subject to such action, (§7623(b)(5)(A)) and

2. If the tax, penalties, interest, additions to tax, and additional amounts in dispute exceed $2 million. (§7623(b)(5)(B))

With respect to nondiscretionary whistleblower awards, §7623(b)(4) provides that any determination regarding an award may, within 30 days of such determination, be appealed to the Tax Court (and the Tax Court will have jurisdiction with respect to that matter). A whistleblower may then appeal the Tax Court's decision to the applicable Court of Appeals. (§7482(a))

Ian D. Smith, a whistleblower, provided information to IRS. Using this information, IRS began examinations of a taxpayer that led to the assessment and collection of almost $20 million.

IRS determined that slightly less than $2 million of the collected proceeds was collected using the information that Smith provided. IRS further determined that, because less than $2 million was based on information that he provided, the $2 million threshold for application of the nondiscretionary award regime of §7623(b) had not been met. Accordingly, IRS made a discretionary whistleblower award under §7623(a).

Smith argued that the "amounts in dispute" referenced in §7623(b)(5)(B) was almost $20 million and that the threshold for use of the nondiscretionary award of §7623(b) was met. Smith contended that IRS had read into §7623(b)(5)(B) a limitation with respect to the $2 million threshold by concluding that "amounts in dispute" include only the amounts of collected proceeds for which the whistleblower provided direct or indirect information.

On the other hand, IRS argued that certain common words or phrases in §7623(b)(1) required it to follow the same quantitative measure in determining the $2 million threshold of §7623(b)(5)(B). In particular, IRS focused on the words "any" and "action" in the context of §7623(b)(1). §7623(b)(1) provides:

"If the Secretary proceeds with any administrative or judicial action described in subsection (a) based on information brought to the Secretary's attention by an individual, such individual shall, subject to paragraph (2), receive an award at least 15 percent but not more than 30 percent of the collected proceeds (including penalties, interest, additions to tax, and additional amounts) resulting from the action (including any related actions) or from any settlement in response to such action. The determination of the amount of such award by the Whistleblower Office shall depend upon the extent to which the individual substantially contributed to such action" [Emphasis added.]

IRS contended that §7623(b)(1) therefore defined the scope of the words "any action" for purposes of §7623(b), and accordingly governed the use of the phrase "any action" in §7623(b)(5).

The Tax Court held that the "amounts in dispute" referenced in the §7623(b)(5)(B) threshold were the total amount of the liability that IRS proposed with respect to a taxpayer's examination that was commenced using the information provided by a whistleblower, and were not limited to the part of the "collected proceeds" attributable to the whistleblower's information or specific allegations.

The Tax Court rejected IRS's contention that the §7623(b)(1) determination of the size or percentage of an award applies only to those portions that were directly or indirectly attributable to the whistleblower's information or that IRS's definition of "amounts in dispute" should be employed to determine whether the $2 million threshold of §7623(b)(5)(B) has been met. The application of IRS's position in this case would lead to anomalous results. Smith's whistleblower claim caused the initiation of an examination that resulted in the collection of almost $20 million of tax and penalties, almost $2 million of which was directly or indirectly attributable to Smith's information. In spite of those results, under IRS's position, §7623(b) would not be applicable in this case.

The Court reasoned that the §7623(b)(5)(B) phrase "amounts in dispute" is not specifically limited to only those amounts directly or indirectly attributable to the whistleblower information. Once the monetary thresholds are met and the Government recovers "collected proceeds" resulting from the action, the mandatory provisions of §7623(b)(1) or §7623(b)(2) apply. Conversely, "collected proceeds" as used in §7623(b)(1) is limited by "resulting from the action," whereas "amounts in dispute" as used in §7623(b)(5) is not.

§7623(b)(5), the Court found, has a clear meaning. It is simply a monetary threshold for application of the §7623(b) award regime. The $200,000 of gross income threshold must be met where the taxpayer is an individual, and the $2 million amount in dispute must be met for any taxpayer. The factors of §7623(b)(1) and §7623(b)(2) limiting the award to a particular portion of collected proceeds focus upon the usefulness of the whistleblower's claim and should not be a refinement of the "amounts in dispute" as used in §7623(b)(5).

The Court found that the $2 million threshold under §7623(b)(5)(B) was met here and that Smith's whistleblower award should be determined under §7623(b).

Smith, (CA 9 7/13/2016) 118 AFTR 2d 2016-5127, cert denied 2/21/2017.

The Supreme Court has declined to review a decision of the Court of Appeals for the Ninth Circuit, which ruled that a taxpayer who failed to make a tax filing until seven years after his return was due and three years after IRS assessed his deficiency did not make "an honest and reasonable attempt" to follow the law. Thus, he failed to file a "return," and his tax liability with respect to that return was not discharged in bankruptcy.

Section 727 of the Bankruptcy Code permits the discharge of debts in Chapter 7 bankruptcies, but contains a number of exceptions, including those in Section 523. (11 USC 727(b)) 11 USC 523 provides, in relevant part: "(a) A discharge under section 727...of this title does not discharge an individual debtor from any debt- (1) for a tax- (B) with respect to which a return, or equivalent report or notice, if required- (i) was not filed or given." For purposes of this rule, the term "return" means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes "a return prepared pursuant to §6020(a), or similar state or local law." (11 USC 523(a))

§6020(a) provides that, if a taxpayer fails to make a return but consents to disclose all information necessary for preparing the return, IRS may prepare the return.

The Courts of Appeal for the First, Fourth, Fifth, Sixth, Seventh, Tenth and Eleventh Circuits (as well as several bankruptcy courts) have held that, unless a return is filed under §6020(a) or a state safe harbor rule similar to §6020(a), an income tax return filed late under applicable nonbankruptcy state law is not a return for discharge purposes. For example, see *Fahey v. Mass. Dep't of Revenue,* (CA 1 2015) 779 F.3d 1; *McCoy v. Mississippi State Tax Commission,* (CA 5 2012) 666 F.3d 924; *Mallo v. IRS,* (CA 10 2014) 114 AFTR 2d 2014-7022.

However, the Eighth Circuit, in *Colsen,* (CA 8 2006) 97 AFTR 2d 2006-2333, and various bankruptcy courts, have held that the "applicable filing requirements" language in 11 USC 523(a) refers to considerations other than timeliness, such as the form and contents of a return.

The "requirements of applicable nonbankruptcy law (including applicable filing requirements)" language in 11 USC 523(a) came into the law in 2005. Prior to that time, bankruptcy courts had adopted a 4-prong test, previously developed in tax matters, to determine whether a document submitted to IRS constituted a "return" for purposes of 11 USC 523(a). This test, commonly known as the Beard test, comes from a Tax Court decision, *Beard,* (1984) 82 TC 766. As adopted by the Ninth Circuit in *Hatton* (CA 9 2000) 86 AFTR 2d 2000-5572, the Beard test establishes the following four requirements for a document to serve as a tax return: (1) it must purport to be a return; (2) it must be executed under penalty of perjury; (3) it must contain sufficient data to allow calculation of tax; and (4) it must represent an honest and reasonable attempt to satisfy the requirements of the tax law.

After Martin Smith failed to timely file his 2001 tax forms, IRS prepared a Substitute for Return or "SFR" based on information it gathered from third parties. In March 2006, IRS mailed Smith a notice of deficiency. Smith did not challenge the notice of deficiency, and IRS assessed a deficiency against him of $70,662. Three years later, in May 2009, Smith filed a Form 1040 for the year 2001 on which he wrote "original return to replace SFR."

On this late-filed form, Smith reported a higher income than the one IRS calculated in its assessment, thereby increasing his tax liability. IRS added the additional arrearage to its assessment. In 2009, Smith started making monthly payments with respect to the assessment.

After about five months, Smith declared bankruptcy and sought to discharge his 2001 tax debt before the bankruptcy court. Smith and IRS agreed that the increase in the assessment based on Smith's late-filed form was dischargeable, but they disputed whether IRS's original $70,662 assessment was also dischargeable.

The bankruptcy court ruled that the original $70,662 assessment was dischargeable. The district court reversed, finding that the $70,662 assessment was not dischargeable. Smith appealed the district court's ruling.

The Ninth Circuit, affirming the district court, held that Smith did not file a return because he did not make "an honest and reasonable attempt" to follow the law. Thus, his tax liability with respect to that return was not discharged in bankruptcy.

The Court said that the facts here were similar to those in Hatton. The taxpayer in Hatton failed to file a tax return, and IRS computed and assessed his tax liability by creating an SFR. Throughout the process, IRS sent numerous notices to Hatton, but it received no responses. Hatton finally met with IRS more than seven years after the original return was due and more than four years after IRS assessed a deficiency. He did not dispute his liability, and IRS agreed to a $200-a-month payment plan. The Hatton court held that Hatton's "belated acceptance of responsibility" was not an honest and reasonable attempt to comply with the Code.

Smith argued that the "honest and reasonable" inquiry requires looking only at the face of the filing and that Hatton's facts were distinguishable because Hatton did not file a tax form at all. The Court here disagreed. It said that Hatton focused the "honest and reasonable" inquiry on the honesty and reasonableness of the taxpayer's conduct, not on any deficiency in the documents' form or content.

The Court noted that the other circuits to have addressed the issue, other than the Eighth Circuit, have held that post-assessment tax filings are not "honest and reasonable" attempts to comply and are therefore not "returns" at all. But, it said, it need not decide the close question of whether any post-assessment filing could be "honest and reasonable" because the facts in this case were not close facts; IRS communicated with Smith for years before assessing a deficiency, and Smith waited several more years before responding to IRS or reporting his 2001 financial information.

On February 21, 2017, the Supreme Court refused to review the Ninth Circuit's decision. Accordingly, that decision is now final.

Snyder & Associates LLC v. U.S. (CA 9 6/16/2017) 119 AFTR 2d ¶ 2017-867.

The Court of Appeals for the Ninth Circuit has reversed the district court's dismissal on immunity grounds of an action that was brought by tax preparation and refund-advance businesses against IRS under the Federal Tort Claims Act, and has remanded the case for further proceedings. As part of a sting operation aimed at catching people filing fraudulent tax refunds, IRS allegedly enlisted the businesses' assistance, used millions of their dollars as bait with a promise of reimbursement (which did not happen), and revoked one business's electronic tax filing privileges (which forced it into bankruptcy).

The Federal Tort Claims Act (FTCA) waives the U.S.'s sovereign immunity for tort claims against the federal government in cases where a private individual would have been liable. (28 U.S.C. §1346(b)(1))

However, 28 U.S.C. §2680 provides for several exceptions that severely limit the FTCA's waiver of sovereign immunity. 28 U.S.C. 2680(a) excepts from the FTCA any claim based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a federal agency or government employee, whether or not the discretion involved is abused. 28 U.S.C. 2680(c) prevents lawsuits against the federal government for any claim arising in respect of the assessment or collection of any tax. 28 U.S.C. 2680(h) excepts claims that arise out of misrepresentations, both those that are willfully made and those negligently made.

Total Tax Preparation, Inc. (TTP) was a tax return preparation business. Its affiliate, Snyder & Associates Acquisitions LLC (SAA) made loans to taxpayers who were awaiting income tax refunds. TTP prepared its clients' federal income tax returns and referred clients who wanted refund advances to SAA. When SAA loaned money based on anticipated tax refunds, its clients instructed IRS to send their refund checks to SAA. Kerry Snyder was TTP's president and SAA's managing member.

In 2010, as part of an IRS trap to catch people filing for fraudulent tax refunds, Nancy Hilton, a tax preparer who worked as an independent contractor, referred several clients to SAA for refund anticipation loans. When one of her clients tried to cash a check issued by SAA, the bank notified Snyder that Hilton's client was using fake identification, and he asked the bank to hold the check and immediately contacted Hilton. She admitted to Snyder that she was working with IRS Criminal Investigations Special Agent Matt Daniels in an undercover sting operation, to catch people making fraudulent claims for tax refunds.

Snyder realized that IRS was unlikely to issue refunds for the fraudulent tax returns filed on behalf of Hilton's clients, and that SAA's ability to collect on its refund anticipation loans was in jeopardy. Snyder requested that the bank stop payment on all checks SAA had issued to Hilton's clients. According to the complaint, Agent Daniels contacted Snyder and informed him that stopping payment would interfere with a federal criminal investigation. Agent Daniels asked Snyder to allow the checks to clear the bank, and assured Snyder that SAA would be repaid. When Snyder called an IRS supervisor to confirm Agent Daniels's representations, the supervisor vouched for the sting operation and for Agent Daniels. Snyder authorized SAA to issue new checks to Hilton's clients, and Agent Daniels and another IRS agent made additional assurances that SAA "would be made whole."

TTP and SAA quickly began to experience negative repercussions from their agreement to cooperate with IRS. TTP's and SAA's bank informed them that it was closing their business accounts because of an inquiry the bank made to IRS about the investigation of TTP's and SAA's clients. They alleged that IRS failed to inform the bank that TTP and SAA were aiding the sting operation at IRS's request. TTP and SAA incurred $12,777 in bank and attorneys' fees to keep their bank accounts open. IRS ignored TTP's and SAA's repeated requests for written confirmation of its promise to repay SAA, and also ignored their requests to reimburse the advanced funds and their bank and attorneys' fees.

IRS never returned SAA's or TTP's money. Instead, at the conclusion of the sting operation, IRS subpoenaed more than 5,000 of their documents to assist with its prosecution efforts and revoked TTP's electronic tax filing privileges-at the beginning of the tax preparation season-forcing both SAA and TTP into bankruptcy. Both sued IRS under the FTCA, alleging several causes of action.

IRS's main argument was that its conduct in this case involved the assessment or collection of taxes because it was trying to determine whether taxpayers were claiming bona fide refunds. Accordingly, any lawsuit was barred under 28 U.S.C. §2680(c). IRS also argued four alternative grounds that the district court did not reach but the Ninth Circuit considered.

On the other hand, the businesses argued that IRS was neither assessing the amount of taxes the filers owed nor attempting to collect taxes from them; rather it was conducting a sting operation aimed at snaring tax cheaters intent on stealing funds from the U.S. treasury. Accordingly, they asserted that 28 U.S.C. §2680(c) did not bar an action against IRS for its tortuous actions.

Granting IRS's motion to dismiss, the district court accepted the argument that 28 U.S.C. §2680(c) shielded IRS from TTP's and SAA's claims.

The majority opinion of the Ninth Circuit held that 28 U.S.C. §2680(c) does not confer absolute immunity on IRS, and, construing the facts in a light most favorable to the businesses because this was a motion to dismiss, found that IRS's sting operation did not arise "in respect of the assessment or collection of any tax."

The Ninth Circuit noted that courts have broadly construed 28 U.S.C. §2680(c) to encompass actions taken during the scope of IRS's tax assessment and collection efforts. 28 U.S.C. §2680(c) has been read to apply to both civil and criminal investigations into potential tax liability, as well as to suits brought against IRS by third parties who never had any tax liability. But despite its expansive reach, it does not grant IRS absolute immunity. Courts have rejected the invitation to read the statute as encompassing any activities that might serve as a deterrent that will facilitate the assessment or collection of taxes generally. (*Capozzoli v. Tracey,* (CA 5 1981) 49 AFTR 2d 82-412)

IRS argued that its conduct in this case involved the assessment or collection of taxes because it was trying to determine whether taxpayers were claiming bona fide refunds. Instead, construing the alleged facts in the businesses' favor, the Ninth Circuit determined that what was at issue was IRS's conduct in a sting operation aimed at snaring tax cheaters intent on stealing funds from the U.S. Treasury. It was not the payment of refunds when due at issue, but fraudsters who filed fake returns; IRS was not assessing the amount of taxes the filers owed, nor was it attempting to collect taxes from them.

Here, it was alleged that IRS revoked TTP's e-filing privileges despite knowing that Snyder did the responsible thing by not stopping payment on checks SAA advanced to Hilton's clients and knowing that TTP's e-filing identification number was used in connection with fraudulent returns at IRS's request. IRS did not attempt to tie the cancellation of TTP's e-filing privileges to any efforts to assess or collect taxes. The only possible links the Court could see between tax assessment and collection and the suspension of the e-filing privileges was that the e-filing system was part of IRS's general mechanism for collecting taxes, and that the revocation of TTP's e-filing privileges was part of a general effort to deter tax fraud. Neither fact was sufficient to support IRS's immunity theory. The Court noted that it had previously rejected an interpretation of 28 U.S.C. §2680(c) that was so expansive that it would negate 28 U.S.C. §2680(h), which expressly allows claims for intentional torts such as malicious prosecution by federal investigative or law enforcement officers. (*Wright v. U.S.,* (CA 9 1983) 719 F.2d 1032)

The Ninth Circuit stated that it was aware of no reported appellate decision that had addressed facts similar to those here, and IRS offered no persuasive reason why it should be the first circuit to grant such expansive immunity. Granting immunity in this case would allow the FTCA's waiver of sovereign immunity to be wholly subsumed in the 28 U.S.C. §2680(c) exception. IRS's all-encompassing view of the 28 U.S.C. §2680(c) exception could not be squared with the statutory text. By its terms, the exception shields only actions taken in connection with efforts to assess or to collect taxes, which were not involved in this case.

The Court also declined to accept IRS's four alternative arguments for affirming the district court's judgment. The Court:

a. Held that 28 U.S.C. §2680(h) does not bar the businesses' claims for negligence, conversion, and failure to restore things wrongfully acquired, rejecting IRS's argument that these claims were premised on misrepresentations by the government. The Court found that 28 U.S.C. §2680(h) bars claims that focus on the government's failure to use due care in communicating information, not actions focused on breach of a different duty. Any other interpretation would encourage the government to shield itself completely from tort liability by adding misrepresentations to whatever otherwise actionable torts it commits.

b. Held that the allegations in the complaint sufficiently stated claims for failure to restore things wrongfully acquired and for conversion under State (California) law. While IRS argued that TTP and SAA failed to state a claim of action because the government never had control over TTP's or SAA's property, TTP and SAA asserted that IRS coerced Snyder into reissuing checks to the targets of the IRS's investigation-which, if proven to be true, might lead a fact finder to conclude that the government exerted sufficient control over their property to support these claims.

c. Found that TTP and SAA stated a claim for abuse of process under State law, rejecting IRS's contention that TTP and SAA cannot show that the IRS committed a willful act in a wrongful manner. Generally, an action for abuse of process lies where the process is used to obtain an unjustifiable collateral advantage. TTP and SAA alleged that IRS issued subpoenas and revoked TTP's e-filing privileges to intimidate them and cause them to drop claims for a return of their funds. If TTP and SAA had dropped their claims, IRS would have obtained a collateral advantage-unchallenged conversion of TTP's and SAA's money. These allegations easily amount to more than mere vexation or harassment.

d. Did not reach IRS's argument that 28 U.S.C. §2680(a)'s discretionary function exception barred the businesses' claims, finding that, at the very least, some discovery on the issue of this exception was warranted. The Court agreed with TTP and SAA's argument that the Federal Rules of Civil Procedure require that they have a chance to conduct discovery on what statutes, regulations, or policies governed an IRS agent's use of private property in the course of a tax fraud investigation. IRS's unsupported assertion that it had unfettered discretion to commandeer TTP's and SAA's funds was not sufficient. Depending on what discovery yields, IRS may be unable to satisfy one of the requirements for this exception by showing that their conduct was discretionary, i.e., that it involved an element of judgment or choice.

Judge Bybee, while concurring in the judgment, wrote separately to address his concern that the majority's blanket conclusion-that IRS was not engaged in "the assessment or collection of any tax" simply because no refunds were due to the subjects of IRS's investigation-was an unduly narrow construction of what constitutes tax assessment and collection under 28 U.S.C. §2680(c). He agreed that the businesses should have an opportunity to show why they can maintain their tort suit against IRS.

Steele, (DC Dist Col 6/1/2017) 119 AFTR 2d ¶ 2017-818.

The District of Columbia district court has held that IRS is authorized to require tax return preparers to obtain preparer tax identification numbers (PTINs) but is not authorized to charge preparers fees to obtain and maintain PTINs. On June 5, IRS announced that, as a result of the court's decision, it is immediately suspending PTIN registration and renewal.

Before 2010, anyone could file a tax return on behalf of someone else, credentialed or not. In 2010, however, IRS, attempting to regulate both credentialed and credentialed tax return preparers, promulgated new regulations. The regulations established a new "registered tax return preparer" (RTRP) designation, requiring individuals other than attorneys and certified public accountants (CPAs) to: "(1) pass a one-time competency exam, (2) pass a suitability check, and (3) obtain a PTIN (and pay the amount provided in the PTIN User Fee regulations)." (Regulations Governing Practice Before the Internal Revenue Service, 76 Fed. Regulation 32286 (June 11, 2011); Regulation §301.7701-15; 31 CFR 10.4(c); 31 CFR 10.3(f); 31 CFR 10.5(b); Regulation §1.6109-2(d))

As statutory authority for these regulations, IRS relied on a provision of the U.S. Code which states that IRS may "(1) regulate the practice of representatives of persons before the Department of the Treasury; and (2) before admitting a representative to practice, require that the representative demonstrate - (A) good character; (B) good reputation; (C) necessary qualifications to enable the representative to provide to persons valuable service; and (D) competency to advise and assist persons in presenting their cases." (31 USC 330(a))

A statutory provision - in effect prior to the new regulations - requires that "any return or claim for refund prepared by a tax return preparer shall bear such identifying number for securing proper identification of such preparer, his employer, or both, as may be prescribed." (§6109(a)(4)) The statute explains that an individual's social security number "shall, except as shall otherwise be specified under regulations...be used as the identifying number." (§6109(d)) When it issued the regulations, IRS required, for the first time, that tax return preparers obtain and exclusively use the PTIN in forms, instructions, or other guidance, rather than a social security number, as the identifying number to be included with the tax return preparer's signature on a tax return or claim for refund. (Furnishing Identifying Number of Tax Return Preparer, 75 Fed. Regulation at 60309; Regulation §1.6109-2(d)) IRS explained the need for the exclusive use of PTINs, as opposed to both PTINs and social security numbers, arguing that "mandating a single type of identifying number for all tax return preparers and assigning a prescribed identifying number to registered tax return preparers is critical to effective oversight." (Furnishing Identifying Number of Tax Return Preparer, 75 Fed. Regulation at 60313) IRS also mentioned that the regulations requiring the use of a PTINs would "help maintain the confidentiality of social security numbers." (Furnishing Identifying Number of Tax Return Preparer, 75 Fed. Regulation at 60309)

The regulations also imposed a user fee requirement for obtaining a PTIN. (Regulation §300.13) As authority for requiring these fees, IRS relied on 31 USC 9701(b), which provides that agencies "may prescribe regulations establishing the charge for a service or thing of value provided by the agency." (User Fees Relating to Enrollment and Preparer Tax Identification Numbers, 75 Fed. Regulation at 60317) IRS stated that a PTIN is a "service or thing of value" because, without a PTIN, "a tax return preparer could not receive compensation for preparing all or substantially all of a federal tax return or claim for refund," and "because only attorneys, certified public accountants, enrolled agents, and registered tax return preparers are eligible to obtain a PTIN, only a subset of the general public is entitled to a PTIN and the special benefit of receiving compensation for the preparation of a return that it confers." (User Fees Relating to Enrollment and Preparer Tax Identification Numbers, 75 Fed. Regulation at 60317)

In 2014, the D.C. Circuit addressed the regulations regarding the exam and education requirements, asking "whether IRS's statutory authority to 'regulate the practice of representatives of persons before the Department of the Treasury' [under 31 USC 330] encompasses authority to regulate tax-return preparers." It concluded that IRS lacked statutory authority to promulgate or enforce those final regulations. It cited several reasons, including: a) tax return preparers are not representatives; and b) tax return preparation does not involve practice before IRS because it does not involve an adversarial proceeding, as envisioned by Congress. (*Loving,* (CA DC 2014) 113 AFTR 2d 2014-867)

Thus, after Loving, the only part of the new regulatory scheme that remains is the PTIN requirement and the attendant PTIN fee requirement.

Two cases regarding these regulations were decided prior to the D.C. Circuit's Loving opinion. First, in *Brannen, III, P.C.,* (DC GA 2011) 109 AFTR 2d 2012-2437, affirmed by (CA 11 2012) 109 AFTR 2d 2012-2442, the court found that Congress, in §6109, specifically authorized IRS to create regulations requiring tax return preparers to identify themselves, by means of identifying numbers, on tax returns and refund claims that they prepare, and therefore IRS did not exceed its authority by issuing regulations requiring the use of PTINs. It then found that the PTIN fee requirement was authorized by 31 USC 9701(b) because PTINs provide a benefit to tax return preparers, stating that "[t]he provision of a PTIN confers a special benefit on tax return preparers, who otherwise would not be permitted to prepare tax returns and refund claims on behalf of others in exchange for compensation."

Buckley, (DC GA 2014) 112 AFTR 2d 2013-7255, came to a similar conclusion. It also found Loving - which at the time was still a district court decision - inapplicable because it "reviewed the competency testing and continuing education requirements for return preparers," which were not at issue in Buckley.

The plaintiffs were a certified class that challenged the regulations requiring tax return preparers to obtain and pay fees for PTINs.

The court found that IRS was authorized to issue regulations requiring the exclusive use of PTINs.

The court noted that there are two standards for reviewing actions of federal agencies. The first such standard was set out in *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.,* (S Ct 1984), 467 U.S. 837, and is often referred to as Chevron deference, The Chevron deference analysis proceeds in two steps. First, "when Congress has spoken to the precise question at issue, we must give effect to the express intent of Congress." Second, "if the statute is silent or ambiguous, however, we defer to the agency's interpretation, if it is a permissible one."

The other standard was set out in *Motor Vehicle Manufacturers Assn's of the U.S., Inc., v. State Farm,* (S Ct 1983) 463 U.S. 29; under this standard, agency actions may be held unlawful if they are arbitrary and capricious.

First, the court said, the plaintiffs' arguments failed step one of Chevron. The statute specifically says that IRS has the authority to specify the required identifying number to be used on prepared tax returns. ("The social security account number issued to an individual for purposes of section 205(c)(2)(A) of the Social Security Act shall, except as shall otherwise be specified under regulations of IRS, be used as the identifying number for such individual for purposes of this title." (Emphasis added)). (§6109(d)) The court must give effect to the unambiguous intent of Congress that IRS may require the use of such a number.

In addition, the decision to require the use of PTINs was not arbitrary or capricious. IRS offered several justifications for the regulation requiring the exclusive use of PTINs. IRS explained the need to identify tax return preparers in order to maintain oversight and stated that the use of a single identifying number was critical to such effective oversight. And, there is a rational connection between the regulations-i.e., requiring the use of PTINs-and the stated rationales-i.e., effective administration and oversight.

The court found that PTINs do not pass muster as a "service or thing of value" for purposes of 31 USC 9701(b), and therefore IRS is not authorized to charge preparers a fee to obtain a PTIN.

The Loving Court concluded that IRS does not have the authority to regulate tax return preparers, and that IRS cannot impose a licensing regime with eligibility requirements on such people as it tried to do in the regulations at issue. Although IRS may require the use of PTINs, it may not charge fees for PTINs because doing so would be equivalent to imposing a regulatory licensing scheme, and IRS does not have such regulatory authority. Granting the ability to prepare tax return for others for compensation- IRS's proposed special benefit-is functionally equivalent to granting the ability to practice before IRS. The Loving Court found that IRS improperly expanded the definition of "practice...before the Department of Treasury." The ability to prepare tax returns is the "practice" identified by IRS in Loving, but the Loving Court found that such an activity does not qualify as practicing before IRS. Therefore, the court here said, it appears that IRS is attempting to grant a benefit that it is not allowed to grant and charge fees for granting such a benefit.

The court acknowledged that Brannen and Buckley found that the PTIN fees are permissible under 31 USC 9701(b). But, it said the Brannen decisions were made prior to the D.C. Circuit's Loving decision, i.e., prior to the finding that IRS lacks the authority to regulate tax return preparers and the striking down of the regulations attempting to do so. And, it disagreed with the Buckley court's finding that Loving (at the time, the district court opinion) is entirely inapplicable because, although the PTIN scheme was authorized by a different statutory authority, it is interrelated with the RTRP scheme.

The court also said that, if tax return preparers were regulated entities required to obtain licenses, this case would be very different. However, Loving makes clear that IRS may not regulate in this area or require that tax return preparers obtain an occupational license. The court said that it was unaware of similar cases in which an agency has been allowed to charge fees under 31 USC 9701(b) for issuing some sort of identifier, when that agency is not allowed to regulate those to whom the identifier is issued. And, the Court said, IRS had not pointed to any.

Additionally, the court noted that after Loving, anyone can obtain a PTIN. They need not meet any type of eligibility criteria. Thus, it is no longer the case that only a subset of the general public may obtain a PTIN and prepare tax returns for others for compensation. Hypothetically, every member of the public could obtain a PTIN, which means that every member of the public would also get the supposed "benefit" of being able to prepare tax returns for others for compensation. There is therefore no special benefit for certain individuals that is not also available to the general public.

Finally, the court addressed IRS's argument that PTINs are things of value because they protect the confidentiality of social security numbers. The confidentiality justification is mentioned only briefly in the Federal register material requiring the use of PTINs. (Furnishing Identifying Number of Tax Return Preparer, 75 Fed. Regulation at 60309) It is not discussed in the regulation that specifically addresses user fees. There was no stated evidence in the administrative record that permitted IRS to make such a determination. The court stated that it "will not defer to these conclusory and unsupported justifications."

On June 5, IRS posted an announcement to its website titled "PTIN System Down" stating that, as a result of the court's decision, it is immediately suspending PTIN registration and renewal. IRS, working with the Department of Justice, is considering how to proceed.

Steele v. U.S., **(DC 7/10/2017) 120 AFTR 2d ¶ 2017-5041.**

In a class action suit, a district court has permanently enjoined IRS from charging fees for a Preparer Tax Identification Number (PTIN) and ordered IRS to make a full refund of all PTIN fees paid from September 1, 2010 to the present.

IRS requires that tax return preparers obtain and exclusively use the PTIN in forms, instructions, or other guidance, rather than a Social Security Number, as the identifying number to be included with the tax return preparer's signature on a tax return or claim for refund. (Furnishing Identifying Number of Tax Return Preparer, 75 Fed. Regulation at 60309; Regulation §1.6109-2(d))

Regulations also impose a user fee requirement for obtaining a PTIN. (Regulation §300.13) As authority for requiring these fees, IRS relied on 31 USC 9701(b), which provides that agencies "may prescribe regulations establishing the charge for a service or thing of value provided by the agency." (User Fees Relating to Enrollment and Preparer Tax Identification Numbers, 75 Fed. Regulation at 60317)

On June 1, 2017, the District of Columbia district court held that IRS was authorized to require tax return preparers to obtain PTINs but was not authorized to charge preparers fees to obtain and maintain PTINs. (*Steele,* (DC Dist Col 6/1/2017) 119 AFTR 2d 2017-2065)

Initially, on June 5, 2017, IRS announced on its website that, as a result of the Steele decision, it suspended PTIN registration and renewal on June 2. It also said that IRS, working with the Department of Justice, was considering how to proceed.

Shortly thereafter, on June 21, 2017, in a website posting, IRS announced that it had put its online PTIN system back online. IRS resumed the issuance of PTINs, but without charge. IRS noted that anyone who prepares, or assists in preparing, all or substantially all of a federal tax return for compensation is required to have a PTIN. All enrolled agents must also have a valid PTIN. The Steele decision upheld IRS's authority to require the use of a PTIN. IRS also noted that the PTIN Helpline would reopen on June 21. And, on the PTIN website, all previously available information, e.g., preparer continuing education records, would be displayed in online PTIN accounts.

IRS, working with the Department of Justice, said it was considering how to proceed with respect to refunding previously paid PTIN fees. Preparers who have any questions on this subject should not contact IRS. Rather, any questions regarding claims or refunds should be directed to the PTIN Fees Class Action Administrator at http://www.ptinclassaction.com. And, IRS will be posting information on its Tax Professionals webpage, https://www.irs.gov/for-tax-pros.

A joint status report in the Steele case issued on June 30, 2017 indicated that IRS had not decided whether it intended to appeal this district court's final judgment. Further, within 14 days from the court entering final judgment, IRS intended to seek a stay of the court's order enjoining it from charging any fee to issue or renew a PTIN, pending its decision on whether to appeal and during the pendency of any such appeal. The plaintiffs did not consent to the proposed stay.

In its final decision, the District of Columbia district court ordered that IRS was permanently enjoined from charging PTIN fees. It further ordered that IRS had to provide each class member with a full refund of all PTIN fees paid from September 1, 2010 to the present.

IRS was to make payment of the refunds to the claims administrator selected by the plaintiffs' counsel promptly after the expiration of the period for appeal or, in the event of an appeal, promptly after the final determination of all appeals or the final judgment of the district court on remand, whichever was later. The claims administrator was directed to process the individual refunds, less the pro rata share of any attorneys' fees and costs approved by the court, to class members within 60 days of the final determination of the amount of any attorneys' fees and costs that may be awarded to the plaintiffs' counsel.

The district court also ordered that the plaintiffs provide notice and an opportunity for exclusion to any class members who have paid initial PTIN fees after August 20, 2016, and did not receive notice of pendency of the action and did not have an opportunity to exclude themselves before December

7, 2016. A separate order was to be entered regarding procedures related to the plaintiffs' plan of notice.

Taft, TC Memo 2017-66.

The Tax Court has granted a wife innocent spouse relief under §6015(b), where her husband hid all financial information from her and filed a joint return without her approval or review. IRS had approved innocent spouse relief under §6015(c) but argued that the wife did not meet all of the requirements for more favorable relief under §6015(b).

Generally, each spouse filing a joint income tax return is jointly and severally liable for the entire tax due. (§6013(d)(3)) Nevertheless, an individual who has made a joint return may elect to seek relief from joint and several liability under, among other Code sections, §6015(b) or §6015(c).

§6015(b) provides full or apportioned relief from joint and several liability for tax to the extent that such liability is attributable to an understatement of tax. To be eligible for relief, the requesting spouse must establish, among other things, that: a) in signing the return, he or she "did not know, and had no reason to know" of the understatement (§6015(b)(1)(C)); and b) taking into account all the facts and circumstances, it would be inequitable to hold the requesting spouse liable for the deficiency attributable to the understatement. (§6015(b)(1)(D)) A spouse seeking relief under §6015(b) has reason to know of the understatement if a reasonably prudent taxpayer in his or her position, at the time he or she signed the return, could be expected to know that the return contained the understatement. (Hopkins, (2003) 121 TC 73)

An election under §6015(c) treats the former spouses as if they had filed separate returns, and each spouse's liability is limited to that portion of the deficiency properly allocable to that spouse. (§6015(c)(1), §6015(d)(3)) Unlike spouses that are granted relief under §6015(b), spouses that are granted §6015(c) relief are not entitled to refunds. (§6015(g)(3))

Mr. Taft married the taxpayer, Brenda, in 1981. Brenda graduated from college with an associate's degree in nursing and began working as a registered nurse. Mr. Taft worked for Publix Supermarkets, Inc. (Publix). One of the benefits of Mr. Taft's employment with Publix was that he received company stock as part of his compensation. Over the years, the value of his stock grew to over $200,000.

In 2009, Mr. Taft was fired from Publix. The following year he began liquidating his stock to fund an extramarital affair. Mr. Taft concealed his stock transactions and his affair from Brenda. When the time came to file their 2010 return, Mr. Taft did not want Brenda to discover the stock liquidation. Therefore, he directed their longtime accountant to electronically file their joint return without Brenda's approval or review. The return reported a $25,000 sale of Publix stock and nearly $200,000 in income from "pensions and annuities." The return, however, failed to report $4,874 Mr. Taft received in taxable dividends. Unbeknownst to Brenda, IRS later assessed the additional tax liability arising from the dividends.

In late 2011, Brenda discovered the affair. She quickly separated from Mr. Taft and filed for divorce. In the course of the divorce proceeding, Brenda learned that Mr. Taft had liquidated all of his Publix stock and that he had wasted most of the family's retirement savings. The divorce became final in 2013.

Shortly after the divorce became final, Brenda filed her 2012 return showing that she was due a refund of $5,261. Instead of issuing the full refund, IRS credited $1,570 to the joint 2010 liability resulting from Mr. Taft's unreported dividends. Brenda filed a Request for Innocent Spouse Relief, requesting that she be relieved of the liability resulting from the unreported dividends and that IRS refund her money that was credited to that liability.

IRS determined that Brenda met the requirements for relief under §6015(c). Consequently, the entire deficiency was allocated to Mr. Taft. However, because spouses that are granted §6015(c) relief are not entitled to refunds, Brenda did not receive a refund of her money that was used to satisfy the deficiency attributable to Mr. Taft. Brenda brought this case seeking relief under §6015(b), which allows for refunds under these circumstances.

The Court rejected IRS's argument that Brenda failed to satisfy the requirements of §6015(b)(1)(C) and §6015(b)(1)(D) and awarded her relief under §6015(b).

The Court said that, in evaluating whether a spouse has "reason to know" under §6015(b)(1)(C), factors to be considered are: (1) the requesting spouse's level of education; (2) the requesting spouse's involvement in the family's business and financial affairs; (3) the presence of expenditures that appear lavish or unusual when compared to the family's past levels of income, standard of living, and spending patterns; and (4) the culpable spouse's evasiveness and deceit concerning the couple's finances. See *Stevens,* (CA 11 1989) 64 AFTR 2d 89-5589. It then looked at each of these factors:

a. **Education**. Brenda had an associate's degree in nursing. She had no accounting or business background and had never taken tax classes. This factor weighed in favor of Brenda. Citing Wang, TC Memo 2014-206, the Court said that the education factor is frequently decided in favor of taxpayers who are highly educated but who lack education in business, accounting, or tax.

b. **Financial affairs.** Brenda credibly testified that she and her husband maintained a great deal of independence from each other when it came to the family's financial affairs. Brenda and Mr. Taft each maintained a separate bank account which the other could not access, and they refrained from opening or reviewing each other's mail. Consequently, Brenda did not have access to the account where the dividends would have been deposited, and she did not review Mr. Taft's mail where the dividends would have been reported. Brenda's role in the family's financial affairs was limited to paying certain household expenses. This factor weighed in favor of Brenda.

c. **Lavish or unusual expenditures.** While Mr. Taft surely made lavish and unusual expenditures in 2010, he concealed them from Brenda and did not make them for her benefit. Mr. Taft spent all his available resources on his secret affair. It was not until late in 2011 that Brenda discovered the affair and the fact that Mr. Taft had wasted his retirement savings. This factor weighed in favor of Brenda.

d. **Culpable spouse's evasiveness or deceit.** Brenda was clearly the victim of Mr. Taft's deceit. Mr. Taft did not want Brenda reviewing their joint return because she would have discovered that he had liquidated the family's retirement savings. Therefore, Mr. Taft directed the accountant to file the return electronically without Brenda's signature or review. When Brenda inquired as to the status of the return, Mr. Taft responded that he "took care of it." This factor weighed in favor of Brenda.

Given that all four factors weighed in favor of Brenda, the Court concluded that Brenda adequately established that she had no reason to know of the understatement.

The Court said that the factors most often cited in determining whether it would be inequitable to hold a spouse liable for a deficiency are whether there has been a significant benefit to that spouse and whether the failure to report the correct tax liability on the joint return resulted from concealment, overreaching, or any other wrongdoing on the part of the other spouse. See, for example, *Jonson,* (2002) 118 TC 106. The Court said that, as it stated in its discussion of §6015(b)(1)(C), the understatement was attributable to Mr. Taft and did not result in any significant benefit to Brenda. The record also established that Mr. Taft concealed his wasteful spending, stock sales, and dividend distributions from Brenda. Under these circumstances, the Court said that it would clearly be inequitable to hold Brenda liable for the deficiency.

Thompson, (2017) 148 TC No. 3.

The §6662A reportable transaction penalty is constitutional and that it does not violate the Eighth Amendment's Excessive Fines Clause.

§6662A(a) imposes a penalty on any reportable transaction understatement. If a taxpayer fails to adequately disclose a reportable transaction giving rise to an understatement under §6662A, the penalty is imposed at a rate of 30%, and there are no available defenses. (§6662A(c), §6664(d)(2)) However, if a taxpayer sufficiently discloses the details of the transaction, the penalty rate is 20% of the amount of the reportable transaction understatement. (§6662A(a)) In this latter instance, a taxpayer may be able to avoid the penalty under §6662A if he shows reasonable cause and good faith, that there is or was substantial authority for a position he took on a tax return, and that he reasonably believed that such treatment was more likely than not the proper treatment of the transaction in question. (§6664(d)(1), §6664(d)(2))

The Eighth Amendment to the United States Constitution provides: "Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted." The Excessive Fines Clause limits the government's power to extract payments, whether in cash or in kind, as punishment for some offense. (*Austin v. United States,* (1993) 509 U.S. 602)

The Supreme Court recognized that taxes are typically motivated by revenue raising rather than punitive purposes. It noted that neither a high rate of taxation nor an obvious deterrent purpose automatically marks a tax as a form of punishment. Nevertheless, the Court found that at some point, an exaction labeled as a tax may approaches punishment. (*Dep't of Revenue of Mont. v. Kurth Ranch,* (1994) 511 U.S. 767)

To pass constitutional muster under the Excessive Fines Clause, the amount of the forfeiture or fine must bear some relationship to the gravity of the offense that it is designed to punish. (*United States v. Bajakajian,* (1998) 524 U.S. 321) The Court in Bajakajian noted that judgments about the appropriate punishment for an offense belong in the first instance to the legislature. The Court then came up with the following test to be used by the trial courts: "If the amount of the forfeiture is grossly disproportional to the gravity of the defendant's offense, it is unconstitutional." Thus, to answer the question whether §6662A violates the Eighth Amendment, a court needs to answer two questions: (1) whether §6662A constitutes punishment for an offense; and (2) whether the punishment is grossly disproportional to the gravity of the offense.

In 2005, Douglas Thompson and Lisa Thompson, husband and wife, participated in a distressed asset debt tax shelter under which they claimed alleged losses from a flow-through distressed asset debt transaction. They reported the alleged loss on their 2015 tax return. The loss was partially carried back to the 2003 and 2004 tax years and carried forward to the 2006 and 2007 tax years to shield their income from taxation. The source of their losses was a listed transaction described in Notice 2008-34, 2008-1 CB 645. Because they failed to disclose the relevant facts relating to the transaction, IRS determined that they were subject to a 30% penalty under §6662A(c). They conceded substantive issues related to this case but contested the issue of liability for penalties.

The Thompsons filed a motion to declare the penalty under §6662A(c) unconstitutional as violating the Excessive Fines Clause of the Eighth Amendment. The taxpayers argued that, because of the way the penalty was calculated, it may be imposed even if there is no actual tax deficiency for the year in question. Moreover, the penalty was calculated at the highest applicable rate of tax.

The Tax Court determined that the §6662A accuracy-related penalties does not violate the Eighth Amendment. The Court rejected the taxpayer's argument that because Congress intended §6662A to deter taxpayers from entering into tax avoidance transactions, it was not purely remedial and was subject to review under the Eighth Amendment as a form of punishment.

But assuming for argument's sake that the Excessive Fines Clause was implicated in this case, the Court found that the penalty under §6662A was not so grossly disproportionate as to fail the Bajakajian test.

The Court reasoned that the §6662A penalty applied only to listed transactions-which are considered per se abusive-and to reportable transactions if a significant purpose is avoidance or evasion of Federal income tax. The penalty is then imposed only if there is a "reportable transaction understatement" as defined in §6662A(b). In many cases, tax shelters represent transactions generating tax losses without corresponding economic losses to investors. These tax losses can be carried back or forward to shield income from taxation over several years (as illustrated in this case).

The taxpayers entered into a listed transaction in 2005 and attempted to partially offset their income with fictitious losses over a span of five years, from 2003 to 2007. As a result, the potential harm to the fisc was spread over several years. Calculation of the §6662A penalty is designed to quantify this harm by taking into account the full tax benefit a taxpayer may have obtained as a result of engaging in a listed or reportable transaction. Thus, it is proportional to the harm caused and does not violate the Bajakajian test.

The Court also rejected the taxpayers' argument that the §6662A 30% penalty for undisclosed transactions violates the Excessive Fines Clause because §6662A imposes a higher penalty rate on undisclosed reportable transactions and takes away defenses that would be available for disclosed transactions. The Court reasoned that legislative history made it clear that Congress saw voluntary disclosure as a key element in curbing the abuse of tax shelters. By imposing a strict liability penalty at a higher rate on undisclosed transactions, Congress wanted to take away taxpayers' ability to ignore or manipulate the existing rules. Tax shelters are notoriously difficult to detect and hard to prosecute. Some promoters and taxpayers, aware of low tax return audit rates, consciously engage in attempts to game the tax system and get away with questionable transactions. The higher penalty may not even make up for the lost revenue and prosecution expenses related to detecting, prosecuting, and resolving these transactions. In any event, it serves as an important deterrent that alters taxpayers' cost-benefit analysis when they consider participating in reportable or listed transactions.

Tilden, (CA 7 1/13/2017) 119 AFTR 2d ¶ 2017-359.

The Court of Appeals for the Seventh Circuit, reversing the Tax Court, has held that the date of the United States Postal Service (USPS)'s entry of taxpayer's envelope into its tracking system is not the equivalent of a postmark date and thus is irrelevant for purposes of the timely-mailing-as-timely-filing rule of §7502. The Court also affirmed previous precedent that the 90-day deadline for filing a Tax Court petition is jurisdictional.

A taxpayer has 90 days (or 150 days if the notice is addressed to a person outside the U.S.) after he receives a notice of deficiency to file a petition with the Tax Court for redetermination of the deficiency. (§6213(a))

§7502(a)(1) provides that, if a taxpayer sends his petition for delivery to the Court "by United States mail" within the prescribed period for filing the petition, and the Court receives the petition after that period has ended, the date of the USPS postmark on the envelope containing the petition will be considered the date of delivery. §7502(b) provides that the rule of §7502(a) applies, in the case of postmarks not made by the USPS, only to the extent provided by regulations.

The relevant regulations provide that §7502 does not apply unless the document is mailed in accordance with the following requirements:

a. If the postmark on the envelope is made other than by the USPS: (i) The postmark so made must bear a legible date on or before the last date, or the last day of the period, prescribed for filing the document; and (ii) The document must be received by the agency, officer, or office with which it is required to be filed not later than the time when a document contained in an envelope that is properly addressed, mailed, and sent by the same class of mail would ordinarily be received if it were postmarked at the same point of origin by the USPS on the last date prescribed for filing the document. (Regulation §301.7502-1(c)(1)(iii)(B)(1))

b. If a document with such a private postmark is received after the time described above, it will nevertheless be treated as timely filed if the taxpayer establishes: (1) that it was actually deposited in the U.S. mail before the last collection of the mail from that particular mailbox that was postmarked (except for metered mail) by the USPS on or before the last date for filing the document; (2) that the delay in receiving the document was due to a delay in transmission of the U.S. mail; and (3) the cause of the delay. (Regulation §301.7502-1(c)(1)(iii)(B)(2))

c. Where both a private postage meter mark and a USPS postmark are on an envelope, the private mark is disregarded, and the rules on USPS postmarks apply. (Regulation §301.7502-1(c)(1)(iii)(B)(3))

A law may create a rule that is "jurisdictional." That is, the Supreme Court has distinguished jurisdictional limits-which a court must enforce even if not raised by the parties and whether or not the litigants agree that a filing is proper-from case-processing rules, which may be waived by the parties. See, for example, *United States v. Kwai Fun Wong,* (2015) 135 S Ct 1625.

The last day for the taxpayer, Mr. Tilden, to seek Tax Court review was April 21, 2015. His lawyer prepared the petition, but his lawyer's staff did not put a stamp on the envelope, and the USPS did not apply a postmark. Instead the staff purchased postage from Stamps.com, a service that supplies print-at-home postage. The staff purchased and printed a certified mail label from Stamps.com; it was dated April 21, 2015, and a member of the staff stated that she delivered the envelope to the USPS in Salt Lake City, Utah, on that date. The envelope was entered into the USPS's tracking system for certified mail on April 23. The Tax Court received Tilden's petition on April 29, 2015.

The Tax Court case. In the Tax Court case, Tilden, TC Memo 2015-188, Tilden argued that his filing was timely because he met the requirements of Regulation §301.7502-1(c)(1)(iii)(B)(1). IRS accepted Tilden's contention that the envelope had been delivered to the USPS on April 21 but invoked Regulation §301.7502-1(c)(1)(iii)(B)(2); it argued that eight days (April 21 to 29) is more than the USPS ordinarily takes to deliver certified mail from Utah to Washington, D.C.

The Court, however, said that both parties were wrong and that the rule of Regulation §301.7502-1(c)(1)(iii)(B)(3) applied. The Court conceded that the USPS had not placed a postmark on the envelope. But the judge said that the entry into the USPS tracking system was just as good as a postmark, which meant that April 23 was the date of filing. That was two days late, so the Court dismissed the petition.

Tilden then sought reconsideration by the Tax Court. He observed that the parties had not raised the possibility that tracking data be treated as a postmark made by the USPS. IRS joined Tilden in contending that the judge had been mistaken; it abandoned its earlier position and asked the Tax

Court to apply Regulation §301.7502-1(c)(1)(iii)(B)(1) and deem both of its subsections satisfied. But the judge denied the motion, stating that, because the 90-day limit in §6213(a) is jurisdictional, the Court is not able to accept the parties' agreement.

The Circuit Court agreed with the Tax Court's conclusion that §6213(a) is jurisdictional.

It said that Kwai Fun Wong stands for the rule that (a) filing deadlines are presumptively not jurisdictional, but (b) Congress can make them so, without necessarily using magic words such as "jurisdiction." As it happens, however, §6213(a) does use that word. It provides, among other things: "The Tax Court shall have no jurisdiction to enjoin any action or proceeding or order any refund under this subsection unless a timely petition for a redetermination of the deficiency has been filed and then only in respect of the deficiency that is the subject of such petition." Tilden did not want either an injunction or a refund; he did not pay the assessed deficiencies. But it would be very hard to read §6213(a) as a whole to distinguish these remedies from others, such as ordering IRS to redetermine the deficiency.

The Court said that, for many decades, the Tax Court and multiple courts of appeals have deemed §6213(a) as a whole to be a jurisdictional limit on the Tax Court's adjudicatory competence. It then noted its specific acceptance of one such Tax Court case, *Guralnick,* (2016) 146 TC No. 15, which unanimously concluded that filing deadlines for petitions seeking Tax Court review are jurisdictional under the Supreme Court's current approach.

But the Court nonetheless reversed the Tax Court.

First, it said that the fact that §6213(a) is jurisdictional does not lead to the conclusion that the Tax Court may disregard the parties' agreement that a particular petition has been timely filed. True, litigants cannot stipulate to jurisdiction. But they may agree on the facts that determine jurisdiction.

For example, if in a suit under the diversity jurisdiction statute, 28 USC 1332, the parties agree that the plaintiff is domiciled in Illinois and that the defendant is incorporated in Delaware and has its principal place of business in Texas, a district court need not, indeed must not, look behind that agreement unless the judge suspects that the allegations are collusive. The Tax Court did not suspect that Tilden and IRS colluded to expand its jurisdiction; to the contrary, IRS initially denied that Tilden's petition was timely.

So the Tax Court judge did not have a sound reason to doubt that the envelope was indeed handed to the USPS on April 21, 2015, as IRS has conceded throughout. And when IRS acknowledged that all requirements of Regulation §301.7502-1(c)(1)(iii)(B)(1) had been met-not only that the envelope was deposited on April 21 but also that certified mail often takes eight days to reach the Tax Court from Utah-the only basis for dismissing Tilden's petition would be a legal conclusion that Regulation §301.7502-1(c)(1)(iii)(B)(3) is the sole subsection entitled to a controlling role.

On that subject, the Court agreed with the parties that the Tax Court was mistaken. Regulation §301.7502-1(c)(1)(iii)(B)(3) specifies what happens if an envelope has both a private postmark and a postmark from the USPS. Tilden's envelope had only one postmark. The regulation does not ask whether a date that is not a "postmark" is as good as a postmark. It asks whether there are competing postmarks.

The Court also expressed its doubt with respect to the Tax Court's belief that the date an envelope enters the USPS's tracking system is a sure indicator of the date the envelope was placed in the mail. The USPS does not say that it enters an item into its tracking system as soon as that item is received, And, here, IRS, when it acknowledged that the envelope was received by the USPS on April 21, in effect conceded that the USPS did not do so for Tilden's petition.

The Court reversed and remanded the case for a decision on the merits.

Trimmer, (2017) 148 TC No. 14.

The Tax Court has determined that a retired police officer who received two distributions from his retirement accounts while suffering from major depressive disorder, and failed to roll them over into another qualified retirement account within the requisite 60-day period, was entitled to a hardship waiver under §402(c)(3)(B). The Court rejected IRS's arguments that its examination division lacked the authority to consider such a waiver, finding that it had the authority and abused its discretion in summarily denying the taxpayer's request for relief "on what appears to have been an incomplete understanding of the pertinent statutory provisions" and without addressing or acknowledging the facts spelled out in the request.

There is no immediate tax if distributions from an IRA are rolled over to an IRA or other eligible retirement plan (i.e., qualified trust, governmental §457 plan, §403(a) annuity and §403(b) tax-shelter annuity). For the rollover to be tax-free, the amount distributed from the IRA generally must be recontributed to the IRA or other eligible retirement plan no later than 60 days after the date that the taxpayer received the withdrawal from the IRA. (§402(c)(3)) A distribution rolled over after the 60-day period generally will be included in the taxpayer's gross income (and also may be subject to a 10% premature withdrawal penalty tax if the taxpayer has not yet reached age 59-½). (§72(t))

IRS may waive the 60-day rule if an individual suffers a casualty, disaster, or other event beyond his reasonable control, and not waiving the 60-day rule would be against equity or good conscience (i.e., hardship waiver). (§402(c)(3)(B))

Revenue Procedure 2003-16, 2003-1 CB 359, establishes a letter-ruling procedure for taxpayers to apply for a waiver of the 60-day rollover requirement (i.e., by submitting a private letter ruling (PLR) request and paying a user fee) and sets out several factors that IRS considers in determining whether to waive the 60-day rollover requirement. These factors include time elapsed since the distribution and inability to complete the rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country, postal error, errors committed by a financial institution, etc.

In 2016, after the years at issue in this case, IRS provided a new self-certification procedure designed to help recipients of retirement plan distributions who, due to one or more specified reasons, inadvertently miss the 60-day time limit for properly rolling these amounts into another retirement plan or IRA. (Revenue Procedure 2016-47, 2016-37 IRB 346) That Revenue Procedure also authorized IRS to grant "additional" hardship waivers during the examination of a taxpayer's return.

John Trimmer was a police officer with the New York Police Department (NYPD) for 20 years until he retired on April 30, 2011, when he was 47 years old. Before retiring, he secured a position as a security guard to supplement his pension income and help finance his sons' college educations, but this job fell through shortly after he retired. He was unable to find another position immediately and began experiencing symptoms of major depressive disorder about three weeks after retiring. He had trouble sleeping, lost weight, and rarely left the house.

On May 27 and June 10, Mr. Trimmer received from his retirement accounts two distribution checks, for $99,990 and $1,680. These checks lay on his dresser at home for over a month until he deposited them into a joint bank account with his wife on July 5, 2011.

Mr. Trimmer had customarily handled the family's taxes and also handled their "large-scale" investment decisions, such as planning for retirement and college savings. In 2012, he had to be reminded repeatedly by Mrs. Trimmer to have their 2011 return prepared, which he eventually did. He went to their regular return preparer and gave the preparer Forms 1099-R reporting the two distributions.

On March 29, 2012, the Trimmers filed their 2011 Form 1040 and reported the two distributions as nontaxable. On April 16, 2012, acting upon his return preparer's advice, Mr. Trimmer opened an IRA at the same bank where he had deposited the two distributions and immediately rolled the funds over to the new IRA. The Trimmers did not make any use of the funds between the time they were received and the time they were rolled over.

Mr. Trimmer's depression began to dissipate and, by the summer of 2012, was in remission.

On December 16, 2013, IRS issued the Trimmers a Notice CP2000, Proposed Changes to Your 2011 Form 1040, asserting that they had failed to report $100,700 of taxable retirement income and were liable under §72(t) for an additional 10% tax on premature distributions from a qualified plan, resulting in almost $40,000 of additional taxes. The Notice CP2000 advised the Trimmers that if they disagreed with the proposed changes, they should complete an attached response form and send it to IRS by January 15, 2014; otherwise, the letter indicated, IRS would send petitioners a notice of deficiency reflecting the proposed changes.

The Trimmers requested and received an extension to respond, to April 23, 2014, then eventually responded on April 30, 2014. In the letter, Mr. Trimmer explained that he was depressed at the time, that the money just sat in the bank untouched, that he deposited the money to an IRA before he was notified by IRS, and that paying $40,000 in additional taxes "would absolutely cripple my family." IRS summarily rejected the Trimmers' request for relief, stating that "[t]he law requires you to roll over your distribution within 60 days of the distribution date. If the rollover exceeds the time frame it becomes fully taxable." The denial did not mention IRS's statutory authority to grant hardship waivers or the procedures for applying for one.

IRS issued a notice of deficiency on August 18, 2014, and the Trimmers petitioned the Tax Court.

IRS asserted that:

a. The hardship waiver provisions of §402(c)(3)(B) were inapplicable in this case because the Trimmers failed to request a PLR and pay the associated fee, as required by Revenue Procedure 2003-16;

b. Its examination division did not have the authority, at the time that the Trimmers 2011 return was under exam (i.e., before Revenue Procedure 2016-47 was issued), to determine if they qualified for a waiver;

c. There was no "final determination" which could be subject to judicial review; and

d. The Trimmers failed to establish that Mr. Trimmer was unable to complete the rollovers within 60 days of the distributions.

The Trimmers contended that Mr. Trimmer qualified for a hardship waiver under §402(c)(3)(B) because his failure to make timely rollovers was caused by his depression.

The Tax Court first determined that the IRS examiner did have the authority to consider a hardship waiver when examining the Trimmers' return. The Court found that nothing in Revenue Procedure 2003-16 or §402(c)(3)(B) limited an examiner from doing so, that the relevant Internal Revenue Manual (IRM) provisions showed that examiners have broad authority "to recommend the proper disposition of all identified issues," and that Revenue Procedure 2016-47 was not intended to create a new authority for IRS examiners to consider hardship waivers during examinations but rather was to make clear the existence of that authority.

Next, the Court found that the Trimmers, while not expressly citing to §402(c)(3)(B), clearly requested hardship relief. The IRS agent did not ask that they provide any further information or advise them to submit a PLR request, but instead said that they did not "need to do anything else" then summarily denied the requested relief "on the basis of cursory and incomplete legal analysis that failed to take into account the provision for hardship waivers."

And, the Court concluded that this denial was a "final determination" properly subject to judicial review. The Court reasoned that, contrary to IRS's arguments, "because the denial of a hardship waiver can affect directly the existence and amount of any asserted deficiency-as it does in this case-the procedures Congress has established for judicial review of the Commissioner's deficiency determinations logically contemplate review of such a denial as one element of the deficiency determination."

The Court then framed the issue before it as whether IRS abused its discretion in denying a hardship waiver in this case and concluded that it did. IRS claimed that the Court could not find any abuse of discretion because there the Trimmers did not substantiate Mr. Trimmer's claimed depression, but the Court rejected this argument, finding that no substantiation was ever requested and they were not given an opportunity to present it during the examination. And, the Court found that the Trimmers presented credible evidence (namely, the expert testimony of a social worker) that he did suffer major depressive disorder. Given the authority of the IRS examiner, denying the Trimmers' request-without even acknowledging the facts or circumstances they presented in their letter-was an abuse of discretion.

Finally, the Court analyzed the facts of the case under the factors outlined in Revenue Procedure 2003-16 and found that Mr. Trimmer satisfied the objective factors for a hardship waiver. Notably, the Trimmers never made any use of the distributions other than to deposit them, and they completed a rollover very soon after their return preparer alerted them to a problem. The Court also found that Mr. Trimmer's major depressive disorder constituted a disability for purposes of §402(c)(3)(B), in that it significantly impaired his ability to perform day-to-day activities, and that his failure to satisfy the rollover requirement was attributable to it. The Court also surveyed relevant PLRs and found that, while not precedential, the facts of this case were generally consistent with situations in which IRS granted waivers.

And, given the Court's holding that no portion of the distributions was included in the Trimmers' 2011 gross income, the Court further held that the §72(t) tax was inapplicable.

Trucept, Inc. (DC CA 7/5/2017) 120 AFTR 2d ¶ 2017-5024.

A district court has held that IRS did not establish that it had conducted an adequate search for records in response to a taxpayer's Freedom of Information Act (FOIA) request. The court also ruled on whether IRS's withholding of certain documents was proper under certain FOIA exemptions, finding that IRS established the propriety of certain of the withholdings and did not establish the propriety of other withholdings.

Under the FOIA and IRS regulations, "upon any request for records which... reasonably describes such records," IRS must promptly make such records available. (5 USC 552(a)(3)(A); Regulation §601.702(c)(1)) District courts are directed to conduct a de novo review of the adequacy of an agency's response to a FOIA request. (5 USC 552(a)(4)(B))

This case was one of five actions filed against IRS by related entities. Each case was based on the claim that IRS failed to comply with its obligations under 5 USC 552 to respond to FOIA requests.

The taxpayer, Trucept, submitted its requests after IRS filed a series of liens against it between 2011 and 2013 holding it liable for payroll tax liabilities of other corporations under alter ego and/or successor liability theories. Having received no response from IRS, Trucept initiated this case. IRS filed a motion for summary judgment. The motion indicated that IRS had completed its search for records, had released 2,319 pages in full, and 617 pages in part, of non-exempt documents responsive to Trucept's FOIA request, and that it had fully discharged its obligations under 5 USC 552.

IRS submitted the declaration of Delphine Thomas as proof it conducted an adequate search. Thomas was an IRS Senior Disclosure Specialist whose duties included responding to FOIA requests for IRS records, which, her declaration stated, required her to "have knowledge of the types of documents created and maintained by the various divisions and functions of IRS and an understanding of the provisions of the FOIA."

Thomas stated that the disclosure specialists initially assigned to respond to Trucept's FOIA had retired or were in different positions and were thus "unavailable to declare." Thomas reported on the previously-assigned disclosure specialists' case notes.

Those notes showed that documents responsive to Trucept's requests were located within commingled files maintained by Revenue Officer (RO) Black on over twenty related entities. He had the case files for all of the entities transferred to him and worked them as one large case file. When he received or created new documents, he added them to the commingled file in chronological order, not based on a particular entity, so that the files for Trucept and all of the other entities were all mixed together. His commingled file was stored in 65 boxes which contained 141,000 pages.

Attorneys and law clerks in the Office of Chief Counsel worked from August 2014 through fall 2015 searching for responsive documents within the commingled administrative file. Thomas's declaration provided that "Amidst the approximately 141,000 pages of documents, my colleagues and I located 3,056 pages of documents responsive to Trucept's request...To my knowledge, there are no other records responsive to Trucept's request."

Court cites case law for how to decide the case. The court looked to case law for how to go about deciding the issues in the case. It noted that district courts have historically followed a multi-step inquiry.

First, the district court must determine whether the agency has established that it fully discharged its obligation under FOIA to conduct an adequate search for responsive records. (*Zemansky v. U.S. Environmental Protection Agency,* (CA 9 1985) 767 F.2d 569) To meet this burden, the agency must demonstrate that it has conducted a "search reasonably calculated to uncover all relevant documents." The issue to be resolved is not whether there might exist any other documents possibly responsive to the request, but rather whether the search for those documents was adequate. The agency must show "what records were searched, by whom, and through what process." (*Steinberg v. U.S. Dept. of Justice*, (CA Dist Col 1994) 23 F.3d 548) In demonstrating the adequacy of the search, the agency may rely upon reasonably detailed, nonconclusory affidavits submitted in good faith. (*Weisberg v. U.S. Dept. of Justice,* (CA Dist Col 1984) 745 F.2d 1476) In determining whether an agency has met its burden to prove an adequate search, "the facts must be viewed in the light most favorable to the requestor." (Zemansky)

If the agency satisfies its initial burden, the court proceeds to the second step and considers "whether the agency has proven that the information that it did not disclose falls within one of nine FOIA exemptions" contained in 5 USC 552(b). (*Shannahan,* (DC WA 2009) 103 AFTR 2d 2009-2592)

Agencies seeking to withhold documents pursuant to a FOIA exemption have been required to supply the opposing party and the court with a "Vaughn index," identifying each document withheld, the statutory exemption claimed, and a particularized explanation of how disclosure of the particular document would damage the interest protected by the claimed exemption. (*Wiener v. Fed. Bureau of Investigation,* (CA 91991) 943 F.2d 972) "The purpose of a Vaughn index "is... to afford the requester an opportunity to intelligently advocate release of the withheld documents and to afford the court the opportunity to intelligently judge the contest." (Shannahan)

Finally, if the agency satisfies the above tests, it generally must still disclose any reasonably segregable portions of the withheld documents. (5 USC 552(b)) "The burden is on the agency to establish that all reasonably segregable portions of a document have been segregated and disclosed." (*Pacific Fisheries Inc.,* (CA 9 2008) 102 AFTR 2d 2008-5838)

The court concluded that IRS did not establish that it conducted an adequate search in compliance with FOIA.

Trucept argued that Thomas's declaration was insufficient to demonstrate the adequacy of IRS's search, because it failed to explain what documents the commingled files contained, the methodology used to review the 65 boxes of documents, and the criteria for selecting responsive documents, and because it did not identify the entities whose records were in the commingled file.

The court agreed with Trucept. To sustain its burden, IRS must show what records were searched, by whom, and through what process. Although a "reasonably detailed, nonconclusory" affidavit submitted "in good faith" will generally meet this burden, in key respects, Thomas's declaration was too conclusory to suffice.

First, the declaration provided no indication how IRS interpreted Trucept's FOIA request, nor did it provide an explanation of the scope or categories of documents it determined were responsive to the request. Federal agencies responding to FOIA requests are required to use search methods which can reasonably be expected to yield the information requested. The court said that, without knowing what records IRS was searching for in response to Trucept's request, it had no context for evaluating the reasonableness of IRS's search methods.

Second, Thomas's declaration failed to give sufficient information about IRS's review of the 65 boxes of documents. IRS spent months reviewing the boxes and selecting particular documents, but did not explain what criteria or search parameters the team used to determine which documents to select. Although an agency need only prove its search was "reasonably calculated to uncover all relevant documents," to evaluate the adequacy of IRS's search, the court needed information regarding the document review to determine whether IRS's search of the 65 boxes was reasonable. An agency fails to demonstrate reasonableness of search if it does not explain the process used to conduct the search.

The court then looked at the various documents that IRS did not provide, analyzed whether those documents fell into one of the 5 USC 552(b) exemptions to FOIA, and concluded that IRS established the propriety of withholding certain documents but did not do so with respect to other documents. For example:

a. 5 USC 552(b)(5) (Exemption 5) protects from disclosure inter-agency or intra-agency memorandums or letters that would not be available by law to a party other than an agency in litigation with the agency. "Exemption 5 thus covers the attorney-client privilege, the attorney work-product privilege, and the executive 'deliberative process' privilege." (*Maricopa Audubon Soc'y v. U.S. Forest Serv.,* (CA 9 1997) 108 F.3d 1089)

IRS submitted the declaration of J. Queener, an attorney in IRS's Office of Chief Counsel, in support of its decision to withhold responsive information under Exemption 5. Her declaration indicated the withheld information consisted of confidential written communications between RO Black and Ms. Meigs, an attorney in the IRS Office of Chief Counsel, in which Black sought, and Meigs provided, legal advice concerning Black's collection of Trucept's outstanding tax liabilities, and the alter ego or successor liability status of entities that might be pursued for collection.

The court found the information in the Queener declaration sufficiently detailed and non-conclusory to support the conclusion that the withheld information fell within the scope of the attorney-client privilege. The court also found that IRS complied with its duty to produce reasonably segregable portions of documents containing such information.

The court granted IRS's motion for summary judgment as to its determination that this information was exempt from disclosure pursuant to Exemption 5.

b. 5 USC 552(b)(7)(E) (Exemption 7(E)) protects information compiled for law enforcement purposes from disclosure to the extent it "would disclose techniques and procedures for law enforcement investigations or prosecutions, or would disclose guidelines for law enforcement investigations or prosecutions if such disclosure could reasonably be expected to risk circumvention of the law." To establish this exemption, "the Government must show that the technique that would be disclosed under the FOIA request is a technique unknown to the general public." *(Pully,* (DC VA 1996) 78 AFTR 2d 96-5016)

IRS withheld nine pages of documents pursuant to Exemption 7(E). Ms. Queener averred that the redacted information related to Trucept's "Risk Score," "which reflects IRS's assessment of the priority of having the taxpayer's account assigned to a dedicated collection specialist to actively pursue collection of the taxpayer's outstanding liabilities." However, her declaration did not address whether the Risk Score is a "technique unknown to the general public." Accordingly, IRS's evidence was insufficient to support withholding under Exemption 7(E), and the court denied summary judgment without prejudice as to this exemption.

Twenty-Two Strategic Investment Funds v. U.S., (CA 6/7/2017) 119 AFTR 2d ¶ 2017-825

The Court of Appeals for the Ninth Circuit, affirming the district court, has concluded that a partner's consents to extend the statute of limitations for the assessment of tax attributable to a partnership item were not invalidated by his claim of a third party's alleged conflict of interest or duress.

Under the TEFRA partnership audit rules, the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item) generally is determined at the partnership level. (§6221) If IRS decides to adjust any "partnership items," it must notify the individual partners through an FPAA. (§6226).

Observation: The TEFRA audit procedures were repealed by the Bipartisan Budget Act of 2015 (P.L. 114-74, 11/2/2015), which provided a new set of rules for auditing partnerships and their partnerships at the partnership level that generally apply (subject to an election to apply earlier) to partnership tax years that begin after December 31, 2017.

§6501(a) generally provides that a valid assessment of income tax liability may not be made more than three years after the later of the date the tax return was filed or the due date of the tax return. Subject to exceptions and special rules, the period for assessing tax attributable to a partnership item (or affected item) for a partnership tax year will not expire before the date that is three years after the later of: (1) the date the partnership return was filed, or (2) the last day for filing the return for that year (without regard to extensions). (§6229(a))

IRS may assess additional tax liability against individual partners within one year of the final conclusion of the partnership's tax determination. (§6229(d))

To permit adequate time for the determination of taxpayer's liability, the limitation period on assessment can be extended, before its expiration, by a written agreement (waiver) entered into by the taxpayer and IRS. Further waivers can be executed during the limitation period as extended. (§6501(c)(4), Regulation §301.6501(c)-1(d)

If a taxpayer signs a waiver under duress or coercion, the waiver is invalid. However, where IRS threatened to take legally authorized actions if a taxpayer did not sign a waiver, neither duress nor coercion existed, and the waiver was valid. (Shireman, TC Memo 2004-155) Duress in the tax context is an action by one party which deprives another of his freedom of will to do or not to do a specific act. (*Price*, TC Memo 1981-693)

In *Transpac Drilling Venture 1982-12 v. Commissioner,* (CA 2 1998) 82 AFTR 2d 98-5078, the Second Circuit found that, as a result of being placed under criminal investigation by IRS (and hence becoming subject to pressure by IRS), the tax matters partners of various partnerships labored under a conflict of interest and so their consent to extend the assessment period was invalid. The case involved an unrefuted allegation that IRS had also misled the limited partners who had inquired as to the status of the civil audits by telling them to consult their tax matters partners (who, in turn, had been expressly ordered not to disclose the existence of criminal proceedings against them). The Court found that a "severe conflict cannot be doubted," and refused to allow the tax matters partners to bind the partnerships with their consents.

In *Phillips v. Commissioner*, (CA 9 2001) 88 AFTR 2d 2001-7092, aff’g (2000) 114 TC 115, the Ninth Circuit concluded that the criminal tax investigation of a tax matters partner did not end his power to act for a partnership. Differentiating the case from Transpac, the Court found that in Phillips, IRS made no attempt to get waivers from the limited partners and it was not intuitively obvious that the tax matters partner did what was a routine accommodation-signing a waiver in order to avoid immediate assessment by IRS-in order to ingratiate himself in the investigation of his partnerships. The tax matters partner was not barred from acting as such for the partnerships at issue, and the extensions of the assessment period that he signed were valid.

In 2002, IRS began investigating partnerships employing an investment product called a "Bond Linked Issue Premium Structure" (BLIPS). IRS also began auditing personal tax returns from 1999 and 2000 that claimed BLIPS losses. When it became clear that BLIPS was a tax sheltering scheme and not a true investment vehicle, IRS issued Final Partnership Administration Adjustments (FPAAs) too many of the LLCs that participated in the BLIPS program. The adjustments effectively disallowed tax losses sustained through involvement in the scheme, and resulted in substantial tax liability for the LLCs. The tax matters partner for the funds that constituted the tax shelters challenged the disallowance of losses.

Tom Gonzales, an individual investor, and his single-member LLC (Birch Ventures) intervened in the action. Gonzales participated in BLIPS by forming Birch Ventures, which had obtained a loan and invested the proceeds in the Logan Strategic Investment Fund (Logan). The investment advisory firm, Presidio Growth, LLC (Presidio), was Logan's tax matters partner. Logan filed its 2000 partnership tax return on April 16, 2001, so absent an extension of the statute of limitations, IRS had until April 16, 2004, to assess any taxes with respect to that return.

Gonzales personally signed consents on December 2, 2003, and October 20, 2004, that together extended the limitations period to June 30, 2005. IRS issued a FPAA to Presidio for Logan on April 28, 2005, after the initial limitations period expired but within the extension granted by the consents.

Separately from Presidio, Gonzales moved for summary judgment, arguing that IRS failed to obtain valid extensions of the statute of limitations and that the FPAA issued to Logan was therefore untimely. Gonzales contended that the consents to extend the limitations period that he signed were invalid because his tax advisor had a conflict of interest and he signed the extensions under duress.

Gonzales argued that the consents to extend the limitations period that he personally signed were invalid because of the conflict of interest of his tax accountant and advisor, Steve Smith, because Smith was "instrumental in selling the [tax] shelter to Gonzales," received a commission for involving Gonzales in BLIPS, and signed the 2000 tax return that IRS was auditing. According to Gonzales, IRS was aware of these facts, but did not seek a waiver of the conflict.

Gonzales also argued that his consent to extend the limitations period was obtained under duress inflicted by IRS agent Paul Doerr. Gonzales alleged that Doerr met with Gonzales two times without legal representation present and that he acted improperly by serving a summons at Gonzales' home.

The Ninth Circuit concluded that an alleged third-party conflict of interest, without more, did not vitiate the individual consent personally executed by the taxpayer. And, even crediting Gonzales's allegations, the alleged actions by the IRS agent did not constitute legal duress warranting relief.

The Court reasoned that other than vague implication of wrongdoing, Gonzales offered no evidence that Smith's involvement in promoting BLIPS and his involvement in preparing Gonzales's 2000 tax return combined to create a conflict of interest three years later when IRS approached Gonzales himself about extending the limitations period. There was no evidence in the record that IRS contacted Smith during the time he was advising Gonzales to request that Gonzales agree to extend the limitations period. Nor was there evidence that Smith ever provided any advice to Gonzales regarding extending the limitations period.

Further, as the district court observed, "[a]lthough Steve Smith represented Gonzales during the audit that flowed from his 2000 tax return, Gonzales had designated different representation before signing the consents. Gonzales offered no evidence that his decision to consent to extend time was influenced by Steve Smith notwithstanding this latter designation." It was Gonzales' burden to point to evidence in the record showing a genuine dispute of fact on this point, and he failed to do so.

The Ninth Circuit determined that the district court did not err in concluding that the consents Gonzales signed to extend the limitations period were not invalidated by Steve Smith's alleged conflict of interest. The Court found that Gonzales' reliance on Transpac and Phillips was misplaced. These cases did not stand for the proposition that a third party's alleged conflict of interest-especially absent evidence of government misconduct, or a breach of the third party's fiduciary duty to the taxpayer-invalidated a consent to an extension signed by the taxpayer himself.

Transpac simply did not support Gonzales' argument that his tax advisor's role in promoting BLIPS in 2000 created a conflict sufficient to invalidate his own consent to extend the limitations period in 2003 and again in 2004. Absent from Gonzales' case was any evidence that IRS failed to obtain consent from Gonzales himself, that it sought consent from the tax matters partner after Gonzales expressly declined, or that it thwarted Gonzales's attempts to inform himself about the status of the audit by directing him to the tax matters partner, who was under criminal investigation but forbidden from revealing that fact.

In addition, the Ninth Circuit rejected Gonzales' argument that his consent was obtained under duress. Construing the facts in the light most favorable to Gonzales and assuming that the meetings without legal representation present did take place (although IRS disputed this), the facts still did not justify an inference of duress. The Court found that Gonzales' conclusion was founded on inference. Gonzales could not recall any details of the meeting other than its location. He could not remember any questions agent Doerr asked him or any particular things agent Doerr said that were intimidating or coercive. His testimony was that he was worried that he might be in legal trouble and that IRS could ruin his life. The Court noted that the fact that the IRS agent declined to assure Gonzales that IRS would not be pursuing lawful action against him did not justify an inference that Gonzales was deprived of his freedom of will to such a degree that he signed the consents to the extensions under duress. IRS was legally authorized to investigate and take action against Gonzales, so even if he feared legal trouble, he did not show that this fear sufficed to support a finding of duress.

The Court also rejected Gonzales' contention that the fact that the agent served a summons on him constituted duress. It was agreed by Gonzales and the agent that Gonzales was not home when agent Doerr visited his residence and served his summons, and that he left the summons in the mailbox without encountering anyone. The Court noted that under §7602(a) and §7603(a), IRS agents are authorized by statute to issue summonses, and a summons regarding a tax return is required to be "delivered in hand to the person to whom it is directed, or left at his last and usual place of abode." There was simply no evidence that agent Doerr acted improperly or illegally in serving the summons at Gonzales' home.

In short, there was no evidence to support Gonzales' assertion that his consent to extend the limitations period was obtained under duress.

U.S. v. Acacia Corporate Management, LLC, et al, (CA 9 5/23/2017) 119 AFTR 2d ¶ 2017-783.

The Court of Appeals for the Ninth Circuit, affirming a district court, has concluded that the various related parties purportedly holding interests in the properties at issue were nominees of the taxpayers against whom a deficiency had been assessed. The Court held that IRS's tax liens on the properties were valid.

The nominee doctrine is utilized to determine whether property should be construed as belonging to taxpayers that treated and viewed the property as their own, in spite of the legal machinations employed to grant legal ownership to another party. Nominee status is determined by the degree to which a party exercises control over an entity and its assets. (*Richards v. U.S.,* (DC CA 1999) 83 AFTR 2d 99-1138) The nominee theory attempts to discern whether a taxpayer has engaged in a sort of legal fiction, for federal tax purposes, by placing legal title to property in the hands of another while, in actuality, retaining all or some of the benefits of being the true owner. (*Fourth Investment, LP v. U.S.*, (CA 9 2013) 111 AFTR 2d 2013-2340)

Courts generally apply the following six common-law factors to determine the existence of a nominee relationship:

1. Whether no consideration or inadequate consideration is paid by the nominee;
2. Whether the property was placed in the name of the nominee at a time the taxpayer could have anticipated litigation or liabilities;
3. Whether a close relationship between the transferor and the nominee exists;
4. Whether the parties to the transfer failed to record the conveyance;
5. Whether the transferor retained possession; and
6. Whether the transferor continues to enjoy the benefits of the transferred property.

Vincent and Louise Booth (the Booths) owed IRS over $2 million dollars in tax deficiencies and penalties dating from activity in 1995-1997. The Booths owned (or controlled through other entities) three parcels of property in Bakerfield California: 5705 Muirfield Drive (Muirfield); 5717 Roundup Way (Roundup); and 1927 21st Street (21st Street) (collectively the Subject Properties).

In 1995, the Booths set up three trusts, the Alpha Omega Trust, the Aligned Enterprises Trust, and the Agape Trust. The beneficiaries of the Alpha Omega and Aligned Enterprises Trusts were the Booths' children and the Agape Trust. The Booths were trustees of Alpha Omega and Aligned Enterprises Trusts from 1996 to July 2000.

The Booths transferred ownership of Muirfield and Roundup to the Alpha Omega Trust in July 1996 through quit claim deeds. They received nothing from Alpha Omega Trust in exchange. The Booths transferred 21st Street to Aligned Enterprises Trust in 1996. In the 1990s and 2000s, the Booths resided at Roundup, Vincent Booth used 21st Street as his medical chiropractic office, and Vincent Booth's mother resided at Muirfield. The Booths may have paid rent to the various trusts and entities that held formal title to the Subject Properties.

In 2000, the Booths created liens on the Subject Properties. In these liens (one for each of the Subject Properties), the Booths, as trustors and trustees of the Alpha Omega Trust and Aligned Enterprises Trust, promised to pay Southern Financial Trust (a trust the Booths had created) $4,166.67 per month for 60 months. Each lien was notionally for $500,000, for a total of $1.5 million, and was transferred from Southern Financial Trust to Alpha Omega Trust and Aligned Enterprises Trust. But, no actual money ever changed hands. Southern Financial Trust never paid $1.5 million, and the Booths never made any monthly payments to Southern Financial Trust.

IRS filed a notice of federal tax lien against the Booths, recorded on March 15, 2000. IRS had made tax assessments against the Booths in October and November of 1999.

Sometime in 2000, the Booths also formed the Bakersfield Properties and Trust Company for the purpose of holding the Subject Properties. Alpha Omega Trust and Aligned Enterprises Trust transferred the Subject Properties to Bakersfield Properties and Trust Company on August 2, 2000 (recorded on January 11, 2002). No money exchanged hands in the transactions.

Michael Ioane was hired by the Booths to help them deal with the IRS tax inquiries and to avoid paying income tax due from prior years. Acacia was founded in April 2003 and was owned by Ioane's children. On December 5, 2005, Bakersfield Properties and Trust Company purportedly transferred the Subject Properties to Acacia for $900,000. Acacia in turn transferred a 5% interest in each of the Subject Properties to Ioane. No money exchanged hands in the transactions. While Ioane stated that Acacia gave Bakersfield Properties and Trust Company $5,000 in exchange for the Subject Properties, there was no documentation supporting this claim.

Mariposa Holdings, LLC (Mariposa) was a trust originally initiated by Vincent Booth but not used by him personally. Instead, he turned it over to Ioane to set up and use. The Booths invested in a property development project with Treble LLC in 2004. The Booths agreed to pay $10,000 a month (through Southern Financial Trust) for a total of $950,000 to Treble LLC, and transferred the liens on the Subject Properties (beneficiary Southern Financial Trust) to Treble LLC as collateral. The Booths, who had invested a total of approximately $490,000 into Treble LLC, fell behind on their payments in 2006. To resolve the problem, Treble LLC came to an agreement with Southern Financial Trust to end and repay the Booths' limited investment. IRS contacted Treble LLC about the Booths' tax problems and levied on Southern Financial Trust's payout from Treble LLC.

In December 2005, Ioane told Treble LLC that Southern Financial Trust's interest in the development project was being transferred to Mariposa. On June 9, 2009, to extricate Treble LLC from the tax controversy, Treble LLC agreed to pay Mariposa a total of $427,000 and to transfer the liens on the Subject Properties to Mariposa, believing that the Booths controlled Mariposa and that Southern Financial Trust's interest in Treble LLC was being transferred to Mariposa. IRS then levied on the payout Mariposa received from Treble LLC. Mariposa transferred some interest in one of the Subject Properties to Alpha Enterprises LLC. However, that interest was reconveyed to Mariposa.

On December 22, 2005, IRS put a tax lien on the Subject Properties on the basis that Michael Ioane, Acacia, Mariposa Holdings, LLC, and Alpha Enterprises Trust were the Booths' nominees/alter egos.

The district court concluded that Michael Ioane, Acacia, Mariposa, and Alpha Enterprises were the Booths' nominees. The court determined that Michael Ioane, Acacia, Mariposa, and Alpha Enterprises had no legal interest in the Subject Properties. The district court concluded that tax liens attach to the Subject Properties; that IRS's claims had priority, and that IRS could foreclose on the Booths' properties to satisfy the federal tax liens. (*U.S. v. Booth,* (DC CA 1/10/2014) 113 AFTR 2d 2014-526)

The Ninth Circuit found that the district court did not err in concluding that these taxpayers held title to the Booths' Subject Properties as the Booths' nominees and that all of the transfers of the Subject Properties were shams.

Further, the Court held that the district court properly applied the 6-factor test regarding the existence of a nominee relationship.

1. **Inadequate or no consideration.** The district court did not clearly err in finding that no consideration was paid for the properties. The Booths testified that no money was ever paid for the transfers. While Ioane argued that he assumed $900,000 in debt from the Booths, this was not adequate consideration, as the debt was initially owed to Southern Financial Trust-which the district court held was itself a Booth nominee. And while Ioane also argued that he paid the Booths $15,000 in cash, the district court found Ioane's testimony not credible, and there was no evidence of the payment beyond this testimony.

2. **Anticipation of a lawsuit or other liability.** The district court did not clearly err in finding that the Booths had transferred the Subject Properties to Ioane in 2005 in anticipation of litigation. Ioane argued that the transfers were not made in anticipation of litigation because they took place in 2005, six years after IRS recorded its tax liens. However, Vincent Booth testified that the IRS investigation was "heating up" in 2005 and asserted that he made the transfers in order to avoid IRS scrutiny. Ioane cited no case establishing that a transfer must come within any set window of time before the events giving rise to liability to satisfy this factor.

3. **Close relationship between the nominees and the transferor.** The district court did not clearly err in finding that the Booths and Ioane were close. It was undisputed that Ioane was the Booths' hired consultant, and the Booths testified that he advised them about the purpose of the transfers. Moreover, the record indicated that Ioane acted as the Booths' agent and signed papers on behalf of Bakersfield-which the district court correctly found to be a Booth nominee-in the transfer of the Subject Properties to Acacia. While Ioane asserted that this factor was not satisfied because he and the Booths had no familial connection, a familial connection was not necessary to find a close relationship between nominees and a transferor.

4. **Recording of the conveyances**. The district court did not clearly err in finding that the transfer of the Subject Properties from the Booths was recorded. IRS did not dispute this finding.

5. **Retained possession** and;

6. **Continued to enjoy benefits**. Following the transfer, the Booths continued to live on one of the Subject Properties and maintained an office in another. While Ioane argued that the Booths were rent-paying tenants, witness testimony supported the district court's finding that Ioane and the Booths maintained this arrangement for the sake of appearance.

U.S. v. Commander, (DC NJ 4/3/2017) 119 AFTR 2d ¶2017-620.

A district court has determined on summary judgment that a 50% owner of a member-managed company, who was required to sign off on all significant decisions and actions relating to the company, was liable for the trust fund recovery penalty under §6672. The court found that his role in the company established that he was a responsible person, regardless of whether the other owner had primary responsibility for the company's taxes; and he was found to have acted willfully where he knew (or should have known) that the taxes were unpaid but continued to pay other creditors instead.

§6672 imposes a responsible person penalty (aka trust fund recovery penalty) on any person who: (1) is responsible for collecting, accounting for, and paying over payroll taxes; and (2) willfully fails to perform this responsibility. The amount of the penalty is equal to the amount of the tax that was not collected and paid.

In determining whether an individual is a responsible person, courts consider factors including whether the taxpayer signed the company's tax returns, served as an officer of the corporation or a member of its board of directors, owned a substantial amount of stock in the company, participated in day-to-day management of the company, determined which creditors to pay and when to pay them, had the ability to hire and fire employees, or possessed check writing authority. (*Brounstein v. U.S.,* (CA 3 1992) 71 AFTR 2d 93-1714) Not every factor must be present; instead, a court must consider the totality of the circumstances to determine whether the individual in question had the effective power to pay the taxes owed. There can be more than one responsible person in a business.

Willfulness for purposes of §6672 includes a voluntary, conscious and intentional act to prefer other creditors over the U.S. Thus, if a responsible person knows that withholding taxes are delinquent, and uses corporate funds to pay other expenses, such failure to pay withholding taxes is deemed "willful." (*Mazo v. U.S.,* (CA 5 1979) 43 AFTR 2d 79-853, *Thibodeau v. U.S.,* (CA 11 1987) 60 AFTR 2d 87-5763)

Darren Commander and Kenneth Skerianz (who passed away during the pendency of the action) formed Darken Architectural Woodwork Installation LLC (Company) in 2003. Commander and Skerianz were each 50% owners of Company, signatories of its Operating Agreement, and the sole officers. Company was member-managed, and all decisions and actions and many significant financial transactions had to be with both party's consent.

Skerianz was responsible for hiring field employees, assigning employees to each job, ensuring work was completed in the field, recording hours worked, and distributing employee paychecks. Company failed to pay income and employment taxes for Company employees between 2007 and 2009. Company continued to employ and pay workers through 2009. Trust fund recovery penalties totaling $1.6 million were assessed against Commander in 2010. With interest, that amount has since increased to almost $2 million.

Both Commander and the U.S. moved for summary judgment.

The court found that there were no factual disputes that Commander was a responsible person who acted willfully with respect to Company's tax payments.

The court noted that responsibility is a matter of "status, duty or authority, not knowledge." (*Quattrone Accountants, Inc. v. IRS,* (CA 3 1990) 65 AFTR 2d 90-580) There was no dispute that Commander was a 50% owner, one of two officers of a member-managed company that had failed to pay its trust fund taxes. Commander's approval was required for all company decisions and actions and many significant financial transactions. He also had check-signing authority and power to pay Company's bills and sign paychecks. Commander argued that he did not know of the delinquencies and that Skerianz was solely responsible for paying the taxes, but the court found that whether or not they were Skerianz's responsibility was irrelevant because Commander was, in fact, a responsible person.

The court also concluded that Commander acted "willfully" within the meaning of §6672. In his deposition testimony, Commander said that he became aware that the taxes were not being paid "somewhere between 2007 and 2009," and that he received regular updates about correspondence with IRS during that time. The court said that it appeared that Commander had actual knowledge that the taxes were not being paid, and that as one of two managing members, he clearly ought to have known and was in a position to find out for certain. There was also no dispute that he knew that employers are required to withhold employment and income taxes from their employees' wages. And, given that he nonetheless paid employees and other creditors instead of remedying Company's tax delinquency, the court found that he acted willfully (or at least with reckless disregard for whether the taxes had been paid).

Accordingly, the court granted summary judgment in favor of the government and denied Commander's motion.

U.S. v. Davis, (CA 5, 3/9/2017) 119 AFTR 2d ¶ 2017-529.

The Court of Appeals for the Fifth Circuit, affirming a district court, allowed IRS to seize and sell a residence-which the taxpayer and his wife had purchased with community funds-and apply the proceeds toward a federal tax lien, subject only to prior-recorded superior security interests. The Court also rejected the husband's motion, that if a sale was allowed, to require that the proceeds be distributed to his children who inherited a 50% interest in the residence on his wife's death.

Under §6331(a), IRS can levy on all property and rights to property of a taxpayer on which there is a federal tax lien, in order to collect delinquent taxes. As an alternative to a levy, IRS may bring a lien foreclosure suit under §7403, i.e., an action in federal district court, to reach the funds.

The Supreme Court has determined that State law determines the property interests to which federal tax liens attach. (*Aquilino v. U.S.,* (S Ct 1960) 5 AFTR 2d 1698)

In *U.S. v. Rodgers*, (S Ct 1983) 52 AFTR 2d 83-5042, the Supreme Court held that §7403 empowers a district court to enforce a tax lien by decreeing a forced sale of an entire property in which a delinquent taxpayer has an interest, even though a nondelinquent person also has an interest in the same property. The nondelinquent person is entitled to receive an appropriate portion of the sales proceeds. Under certain circumstances, the district court may use its discretion to disallow a request for the forced sale. This discretion should be exercised in the light of the following considerations:

a. The extent to which government financial interests would be prejudiced by relegating it to a forced sale of the partial interest;

b. Whether an innocent/nondelinquent third-party has a legitimate or legal expectation that his separate interest would not be subject to a forced sale by the delinquent taxpayer or his creditors;

c. The likely prejudice to the third party, both in personal dislocation costs and in practical undercompensation; and

d. The relative character and value of the nonliable and liable interests held in the property.

Under Louisiana community property law, where property is owned by spouses as community property, each owns an undivided one-half interest in it. (LA. Civ. Code arts. 2336, 2338) A separate obligation of a spouse is one incurred during the existence of a community property regime though not for the common interest of the spouses or for the interest of the other spouse. (LA. Civ. Code art. 2363) On the death of one of the spouses, the community property regime is terminated. (LA. Civ. Code arts. 2356) Louisiana law provides that a separate obligation incurred by one spouse during the community property regime may be satisfied from community property even after termination of the regime from the property of the former community. (LA. Civ. Code arts. 2345, 2357)

In May 1989, S.P. Davis, Sr. (Davis) and his wife Sharon used community funds to purchase a lot and build a residence on the lot (collectively, the Property).

In August 2002, IRS assessed a trust fund recovery penalty against Davis for the unpaid federal employment taxes for three related medical companies that Davis co-owned. As a result of the assessments, a federal tax lien attached to all of Davis's property and rights.

In May 2013, Sharon died intestate, and as a result, Davis remained full owner of 50% of the Property, and their adult children, S.P. Davis, Jr. (S.P.) and Kharmen Davis (Kharmen), each inherited a 25% "naked" ownership interest (similar to a remainderman' s interest in a common law state) in the other 50% of the Property, subject to Davis's right to use the Property (i.e., a "usufruct" right under Louisiana law).

In 2008, the district court found that Davis was jointly and severally liable with the medical companies' other co-owners for more than $3.1 million in federal tax liabilities, plus accrued interest. The court concluded that Davis and the companies' co-owners, as persons responsible for the collection and payment of the employment taxes of the corporate entities, willfully failed to make the tax payments. Davis was ordered to pay the government $3,327 per month until the judgment was satisfied. He failed to comply with the district court's order.

In June 2012, IRS filed suit to foreclose its federal tax lien on the Property, have it sold, and apply the proceeds of the sale to Davis's federal tax liabilities. IRS initially named Davis, Sharon, and Regions Bank (Regions), which held a mortgage that encumbers the Property, as defendants, but substituted S.P. and Kharmen in Sharon's place after her death. The district court concluded that IRS could seize and sell the Property and apply the proceeds toward the federal tax lien, subject only to prior-recorded superior security interests. The court held that a foreclosure sale of the Property was an appropriate remedy in light of the amount of money that was owed by Davis, and the lapse of almost seven years from the entry of judgment.

Davis, S.P. and Kharmen appealed, contending that the district court "erred in refusing to exercise its discretion and prohibit the sale and seizure of the subject property" based on the fact that §7403 gives the district court "reasoned discretion" to decline to order a sale to enforce a federal tax lien. In the alternative, they argued that if the court allows IRS to foreclose on and sell the Property, the proceeds should be distributed to his children who inherited interests in the residence on Sharon's death.

The Fifth Circuit affirmed the district court, concluding that although §7403 gives the district court discretion to decline to order a sale to enforce a federal tax lien, under Rodgers that limited discretion should be exercised rigorously and sparingly, keeping in mind the government's paramount interest in prompt and certain collection of delinquent taxes. The Court could not say that, in light of Davis's failure to comply with the district court's order to make monthly payments of $3,327 to satisfy the judgment, the district court reversibly erred in refusing to exercise its limited discretion to decline to order the sale of the Property.

The Court noted that here, the tax lien, which attached in August 2002 during the Davises' marriage, was a separate obligation incurred by Davis during the community property regime. The Property was owned by Davis and Sharon as community property, and each owned an undivided one-half interest in it. Under Louisiana law, a separate obligation incurred by one spouse during the community property regime may be satisfied from community property even "after termination of the regime from the property of the former community." Therefore, the Fifth Circuit determined that the Property remained subject to seizure and sale under §7403, and the district court appropriately granted summary judgment for IRS.

The Court also rejected the taxpayers' alternative argument that Kharmen and S.P. were each entitled to one-fourth of any sale proceeds that remain after satisfaction of the debt securing the mortgage. The Court reasoned that Kharmen and S.P. each inherited a 25% "naked" ownership interest in the Property, subject to Davis's right to use the Property and encumbered by the federal tax lien that attached to the entire community property during Sharon' lifetime. Accordingly, in light of the well-established principle that "the first in time is the first in right," Kharmen's and S.P.'s interests were inferior to IRS's.

U.S. v. Hartman, (DC MI 8/16/2017) 120 AFTR 2d ¶ 2017-5158.

Vacating its original opinion in light of the recent decision by the Sixth Circuit in Byrne, a district court again concluded that the taxpayer, a 50% co-owner and chief executive officer (CEO) of the company, was liable for the §6672 trust fund recovery penalty. In the recent decision, the Sixth Circuit adopted a "reasonable-cause exception" to the reckless-disregard determination, under which a responsible person's failure to cause the withholding taxes to be paid was not willful if he believed that the taxes were being paid, so long as that belief was reasonable under the circumstances.

Under §6672(a), if an employer fails to properly pay over its payroll taxes, IRS can seek to collect a trust fund recovery penalty equal to 100% of the unpaid taxes from a person who: (1) is a "responsible person"-i.e., one who is responsible for collecting, accounting for, and paying over payroll taxes; and (2) willfully fails to perform this responsibility.

In determining who is a responsible person, the courts generally look at several factors. In the Sixth Circuit, these factors include: (1) the duties of the officer as outlined by the corporate by-laws; (2) the ability of the individual to sign checks of the corporation; (3) the identity of the officers, directors, and shareholders of the corporation; (4) the identity of the individuals who hired and fired employees; and (5) the identity of the individuals who are in control of the financial affairs of the corporation. Liability requires the existence of significant (as opposed to absolute) control of a corporation's finances. Generally, such a person is the one with the ultimate authority over expenditure of funds since such a person can fairly be said to be responsible for the corporation's failure to pay over its taxes or more explicitly, one who has the authority to direct payment of creditors. (*Kinnie v. U.S.,* (CA 6 1993) 71 AFTR 2d 93-1979)

In Kinnie, the taxpayer was the vice-president and 50% shareholder of a company during all the quarters that it failed to pay withholding taxes. He had authority to sign checks on behalf of the company. He had an accountant review the books for possible diversion of corporate funds and subsequently forced the company's president and 50% shareholder, who ran the company on a day-to-day basis, to leave. Kinnie maintained that he was only a "passive investor." But the Sixth Circuit rejected Kinnie's defense that he had "delegated" the duty to pay the taxes to the company's president, stating that there could be more than one person deemed a responsible person within a corporation, and one who possesses significant control over the company's financial affairs cannot escape liability by delegating the task of paying over the taxes to someone else.

A failure to pay over taxes is willful for §6672 purposes if a responsible person makes a deliberate choice to voluntarily, consciously, and intentionally pay other creditors rather than make tax payments. Willful conduct may also include a reckless disregard for obvious or known risks. More than mere negligence is required for willfulness; a person is not willful if as a result of negligence he is unaware of the default in the payment of payroll taxes. However, a reckless disregard of the facts and known risks that taxes were not being paid is sufficient to hold a responsible party liable. (*Calderone v. U.S.,* (CA 6 1986) 58 AFTR 2d 86-5703)

In *Harold v. U.S.,* (CA 6 2006) 98 AFTR 2d 2006-5999, the Sixth Circuit held that there was no question of material fact whether a taxpayer willfully failed to remit the taxes, largely on the basis that the taxpayer was indisputably aware that the company was having tax problems. The taxpayer, a responsible person by his own admission, "did nothing" to ensure that IRS was fully paid even though the company had the proceeds to pay the taxes. Instead, he "assumed" that others would take care of it.

In *Byrne v. U.S.,* (CA6 5/15/2017) 119 AFTR 2d 2017-1824, the Sixth Circuit vacated and remanded a district court decision that had held corporate officers were liable for the §6672(a) trust fund recovery penalty as a result of the controller's fraudulent activities. The taxpayers, the company's president and CEO/chairman, had hired a certified public accounting (CPA) firm, a new chief financial officer (CFO) who oversaw the actual wrongdoer employee, and a third-party accountant. Nevertheless, these entities (i) failed to uncover the well-concealed underpayments after a weeks-long, full-scope audit of the company's finances; and (ii) affirmatively represented to IRS and the taxpayers that the taxes had been paid during the quarters at issue, and that the company was a responsible taxpayer. The Sixth Circuit rejected the district court's conclusion that the taxpayers should have performed their own independent review of the CPA firm's statements, finding that requiring independent verification was unreasonable absent "prior indication of errors or inaccuracies" in the CPA firm's accounting. However-even considering all of the safeguards in place and the reassurances delivered to the taxpayers-the Sixth Circuit labeled its decision to vacate the judgment against them as a "close call."

In *Byrne*, the Sixth Circuit identified certain factual scenarios in which a finding of willfulness could be based on reckless disregard, including: (1) reliance upon the statements of a person in control of the finances when the circumstances show that the responsible person knew the person to be unreliable; and (2) failure to investigate or to correct mismanagement after having notice of nonpayment of withholding taxes.

Jon Hartman was a 50% co-owner and CEO of Spectrum Tool & Design, Inc. while the company operated from April 2001 to October 2005. Dan Ott was a 50% co-owner and chief operating officer (COO) from April 2001 until Hartman laid him off in August 2005. Both Hartman and Ott had authority to handle money for Spectrum, open and close bank accounts in its name, and sign checks.

Generally, Hartman signed employees' paychecks, while Ott prepared the payroll tax deposit checks. Until December 2003, Spectrum used a third-party payroll service provider, ADP, to process its paychecks. But in December 2003, Spectrum was unable to remit the full amount of gross payroll (i.e., including employment taxes) due to ADP, and ADP terminated its contract with Spectrum. Spectrum was, however, able to pay employees their net payroll (i.e., not including employment taxes) during this period. Hartman knew Spectrum could not timely pay its payroll taxes in December 2003, but he and Ott anticipated that they would be able to pay back the shortfall in January or

February 2004. After being dropped by ADP, Spectrum began using an in-house software system for handling payroll, at Ott's behest.

Hartman maintained that Ott was the sole person entrusted to ensure that Spectrum paid its employment taxes. Hartman contended that he did not learn that Ott was routinely failing to pay the payroll taxes until July 2004-at which time he arranged a meeting with IRS to discuss the shortfalls. Going through Ott's desk, Hartman discovered that despite Ott having regularly cut (i.e., created) payroll tax checks, he had not paid the taxes. Up until that point, Hartman claimed that Ott's regularly creating payroll tax checks had led Hartman to believe Ott was paying the taxes.

Despite its attempts, Spectrum could not stay current, necessitating another meeting by Hartman with IRS in October 2004. At the October meeting, Hartman stated that he discovered that Ott had not been keeping up with Spectrum's current taxes. He also claimed that, during the period at issue, Spectrum's in-house accounting software reflected that the payroll tax checks were being cut. In January 2005, Spectrum filed for Chapter 11 bankruptcy protection. Hartman acknowledged that he signed tax returns (Form 941) but claimed that he was "just signing papers that had to be signed," and that he did not review the returns or understand them.

In May 2005, an IRS Revenue Officer interviewed Hartman. He admitted that he first became aware of the delinquent taxes in December 2003 and that while the delinquent taxes were increasing, he authorized the payment of certain of Spectrum's other financial obligations, including payroll, utilities, rent, supplies, operating expenses, loan payments, and equipment leases.

Hartman laid off Ott in August 2005 for performance issues. But, even after he fired Ott, he still used Ott to pay Spectrum's employment taxes.

Following an investigation, IRS assessed trust fund liabilities against Hartman.

The district court found that Hartman was a responsible person under §6672 and that he willfully failed to pay over the employment taxes.

While it was undisputed that, in practice, Hartman had no responsibilities related to calculating or paying the payroll taxes, it was also undisputed that he had the authority to pay the payroll taxes if he wished to do so. As in Kinnie, Hartman possessed the status, duty, and authority necessary to be a responsible person under §6672, as shown by his title, his stock ownership, his check writing authority, and his ability to force the co-owner out of the business and close down the company.

The district court found that every single basis for finding the taxpayer in Kinnie to be a responsible person was present in Hartman's case. Like the taxpayer in Kinnie, the fact that Hartman did not always exercise his powers during the quarters at issue did not absolve him of his responsibility. The district court also noted that, just as the taxpayer in Kinnie was able to commission an inspection of the books to see if his partner was misappropriating funds, Hartman initiated meetings with IRS upon discovering that the accounting balances did not add up. In fact, the court found, Hartman had more responsibility and involvement than the taxpayer in Kinnie because Hartman assumed the duties of handling payroll and payments to non-IRS creditors.

Looking to Harold, the district court also found that Hartman recklessly disregarded an obvious risk that the taxes were not being paid. While Hartman became fully aware of Ott's deception in July 2004, he attempted to show that he had no idea that Ott was "cooking the books"-and that Hartman had no reason to exercise oversight of Ott-until the fourth quarter of 2004 or "later." The court found that the records showed that Hartman discovered Ott's suspicious accounting during the previous quarter, yet, despite this, he continued to trust Ott to pay the taxes until October 2004, after which he learned, again, that the taxes were not being remitted. Yet, Hartman again placed his trust in Ott following the October 2004 conference and declined to exercise any oversight of Spectrum's accounting.

Observation: The district court's revised opinion presented substantially the same reasoning and conclusions on the issue of willfulness as the previous opinion in this case (*U.S. v. Hartman,* (DC MI 7/26/2017) 120 AFTR 2d 2017-5300, but based on the Byrne decision, rather than that of *In re Premo,* (Bktcy Ct MI 1990) 71A AFTR 2d 93-4677.

The district court concluded that Hartman demonstrated both types of recklessness described above in Byrne. Three separate red flags should have caused Hartman, as a responsible person, to exercise oversight of the taxes. Hartman claimed that, following the October 2004 conference, he attempted to investigate whether Ott was complying with his duties by scrutinizing Spectrum's accounting software, and he found that the checks to pay the payroll taxes were cut. However, the district court noted that the fact that a check was cut did not mean that the taxes had been paid-something Hartman should have realized when he found unremitted checks in Ott's desk in July 2004, despite the fact of those checks having also been cut.

The court determined that Hartman's case was nothing like Byrne. Hartman conceded that, as early as July 2004, his suspicions were substantial enough to cause him to rifle through Ott's desk where he discovered that, not only were taxes not being remitted, but Ott had manipulated the accounting software to reflect that the checks were, in fact, being remitted. Going forward, Hartman then purported to have relied on the accounting software and Ott's assurances at a July 2004 meeting with the IRS, despite repeated reaffirmations that Ott was not paying the taxes. And none of the mitigating circumstances in Byrne-such as the reassurances of a CPA, or indicia that Ott's deception was well concealed (it clearly was not) - were present here. Unlike Hartman, the Byrne taxpayers did not simply take the wrongdoer employee at his word regarding tax compliance.

By disregarding repeated red flags that Ott was not paying the payroll taxes, Hartman acted recklessly-and, so, willfully-under §6672. Hartman's only arguments to the contrary, such as that he did not discover Ott's failure to timely remit the payroll taxes until a later date, were contradicted by the record.

U.S. v. Hartman, (DC MI 7/26/2017) 120 AFTR 2d ¶ 2017-5091.

A district court, granting IRS summary judgment, has concluded that the taxpayer, a 50% co-owner and chief executive officer (CEO) of a company, was liable for the §6672 penalty, finding that there was no legitimate factual disputes as to whether he was a responsible person and as to whether he acted recklessly in failing to pay the trust fund taxes.

Under §6672(a), if an employer fails to properly pay over its payroll taxes, IRS can seek to collect a trust fund recovery penalty equal to 100% of the unpaid taxes from a person who: (1) is a "responsible person"-i.e., one who is responsible for collecting, accounting for, and paying over payroll taxes; and (2) willfully fails to perform this responsibility.

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In In re *Premo,* (Bktcy Ct MI 1990) 71A AFTR 2d 93-4677, the court listed typical scenarios in which a finding of willfulness can be based on reckless disregard, including (1) reliance upon the statements of a person in control of the finances of a company where the responsible person knew that the person making the statements was unreliable; this requires a finding that the responsible person had knowledge that the other individual had in the past failed to perform adequately with regard to the financial affairs of the taxpayer entity; and (2) a failure to investigate or to correct mismanagement after having noticed that withholding taxes have not been remitted to the government; this requires a finding that the responsible person had notice that the taxes had not been remitted in the past.

Jon R. Hartman was a 50% co-owner and CEO of Spectrum Tool & Design, Inc. while the company operated from April 2001 to October 2005. Dan Ott was a 50% co-owner and chief operating officer (COO) from April 2001 until Hartman laid him off in August 2005. Both Hartman and Ott had authority to handle money for Spectrum, open and close bank accounts in its name, and sign checks.

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Despite its attempts, Spectrum could not stay current, necessitating another meeting by Hartman with IRS in October 2004. At the October meeting, Hartman stated that he discovered that Ott had not been keeping up with Spectrum's current taxes. He also claimed that, during the period at issue, Spectrum's in-house accounting software reflected that the payroll tax checks were being cut. In January 2005, Spectrum filed for Chapter 11 bankruptcy protection. Hartman acknowledges that he signed tax returns (Form 941) but claimed that he was "just signing papers that had to be signed," and that he did not review the returns or understand them.

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The district court found that every single basis for finding the taxpayer in Kinnie to be a responsible person was present in Hartman's case. Like the taxpayer in Kinnie, the fact that Hartman did not always exercise his powers during the quarters at issue did not absolve him of his responsibility. The district court also noted that, just as the taxpayer in Kinnie was able to commission an inspection of the books to see if his partner was misappropriating funds, Hartman initiated meetings with IRS upon discovering that the accounting balances did not add up. In fact, the court found, Hartman had more responsibility and involvement than the taxpayer in Kinnie because Hartman assumed the duties of handling payroll and payments to non-IRS creditors.

Looking to Harold, the district court also found that Hartman recklessly disregarded an obvious risk that the taxes were not being paid. While Hartman became fully aware of Ott's deception in July 2004, he attempted to show that he had no idea that Ott was cooking the books-and that Hartman had no reason to exercise oversight of Ott-until the fourth quarter of 2004 or "later." The court found that the records showed that Hartman discovered Ott's fishy accounting during the previous quarter, yet, despite this, he continued to trust Ott to pay the taxes until October 2004, after which he learned, again, that the taxes were not being remitted. Yet, Hartman again placed his trust in Ott following the October 2004 conference and declined to exercise any oversight of Spectrum's accounting.

The district court concluded that Hartman demonstrated both types of recklessness described above in In re Premo. Three separate red flags should have caused Hartman, as a responsible person, to exercise oversight of the taxes. Hartman claimed that following the October 2004 conference, he attempted to investigate whether Ott was complying with his duties by scrutinizing Spectrum's accounting software and he found that the checks to pay the payroll taxes were cut. However, the district court noted that the fact that a check was cut did not mean that the taxes had been paid-something Hartman should have realized when he found unremitted checks in Ott's desk in July 2004, despite the fact of those checks having also been cut.

By disregarding repeated red flags that Ott was not paying the payroll taxes, Hartman acted recklessly-and, so, willfully-under §6672. Hartman's only arguments to the contrary, such as that he did not discover Ott's inability to timely remit the payroll taxes until a later date, were contradicted by the record.

U.S. v. Holmes, (CA 5 06/06/2017) 119 AFTR 2d ¶2017-823.

The Court of Appeals for the Fifth Circuit, affirming a district court, has held that IRS's action to collect unpaid estate taxes from the executrix of an estate and her husband was timely under §6502(a)(1). The Appellate Court also concluded that the taxpayers were not entitled to wrongful collection damages under §7433 for being denied the opportunity to refinance their home on more favorable terms due to an IRS lien being improperly filed against them personally.

A tax that has been timely assessed may be collected by seizure of property by levy or by a court proceeding if the levy is made or the court proceeding is begun within 10 years after the date of the assessment. (§6502(a)(1))

§6320(a)(1) and §6330(a)(1) require IRS to give a taxpayer written notice when a Federal tax lien is filed upon the taxpayer's property or IRS intends to levy upon the taxpayer's property. The notice must inform the taxpayer of the right to request an administrative collection due process (CDP) hearing in the IRS Appeals Office.

Under §6320(a)(3)(B) and §6330(a)(3)(B), a taxpayer has 30 days to request a CDP hearing after receiving the notice. Pursuant to Regulation §301.6330-1(i), a taxpayer who misses the deadline to request a CDP hearing may request a hearing known as an "equivalent hearing." The determination from an equivalent hearing is not a formal "Notice of Determination," but rather is a "Decision Letter" and generally is not judicially reviewable.

If a person requests a CDP hearing regarding a levy, the levy actions which are the subject of the requested hearing and the running of the limitations periods under §6502 are suspended for the period during which the hearing, and appeals from the hearing, are pending. These periods will not expire before the 90th day after the day on which there is a final determination in the hearing. (§6330(e)(1)) §6320(c), expressly dealing with liens, incorporates by reference the tolling provisions of §6330(e).

A taxpayer may bring an action against the U.S. when an officer or employee of IRS disregards, either recklessly, intentionally or negligently, any statutory or regulatory provision "in connection with any collection of Federal tax with respect to a taxpayer." (§7433(a)) This provision is a limited exception to the general rule that the U.S., as sovereign, is immune from suit.

Shirley Bernhardt died in October 1997, leaving all that she had to her nephew, Kevin Holmes, a certified public accountant and tax attorney, and his wife Barbara, who was executrix of the estate. Kevin prepared and filed an estate tax return in July 1998 reporting a gross estate of $2.9 million and taxes of $700,000, which the estate paid at that time. In June 2001, IRS audited the estate and issued a notice of deficiency that increased its value at $4.7 million, resulting in the estate owing an additional $1.2 million in tax.

The taxpayers did not agree and filed a petition in the Tax Court. In June of 2004, the Court entered a stipulated decision that the estate owed an additional $215,264. The taxpayers never paid this amount, and, with interest, penalties, and fees, the amount owed grew to $530,000 by March of 2015.

In 2013 and 2014, IRS began placing liens on real property in the name of the estate and Barbara Holmes. It also issued a Notice of Intent to Levy on September 27, 2013, that included a statement that the estate could request a CDP hearing. The estate did so on October 5, 2013, by sending a letter to IRS, via certified mail, containing two forms: Form 12153, "Request for a Collection Due Process or Equivalent Hearing," and a Form 2848, "Power of Attorney." This was around the same time as a federal government shutdown (October 1 to October 16, 2013), and the parties contest if and when IRS received the letter.

In May of 2014, Kevin wrote a letter to IRS insisting that it must have received his letter with the request for a CDP hearing, enclosing a copy of the certified mail receipt as support. IRS's Office of Appeals considered the hearing request to have been received on October 6, 2013, based on the receipt that Kevin provided, and went on to sustain the amount of the levy.

On March 10, 2015, IRS commenced this case in federal district court against Barbara, Kevin, and the estate in order to foreclose outstanding liens and obtain a money judgment for the unpaid taxes, penalties, and fees. Barbara and Kevin counterclaimed for damages under §7433, alleging that they had lost out on a chance to refinance their home at a lower rate of interest due to the filing of an improper lien, which they said they were not given notice of and should not have been filed against them personally but only against the estate.

IRS moved for summary judgment on its own claim and the taxpayers' counterclaim. The taxpayers also sought summary judgment as to IRS's claim on limitations grounds, asserting that the limitations period tolling did not begin on October 5, 2013, but rather in May of 2014, thus rendering IRS's claim untimely, i.e., filed after the 10-year period in §6502(a)(1). The district court granted the government's motion in part (declining to enter summary judgment as to Barbara and Kevin personally) and denied the taxpayers' motion, rejecting the taxpayers' limitations argument on duty of consistency grounds (i.e., that, because they had argued IRS received the letter for purposes of getting a CDP hearing, they could not now argue receipt on a different date) and finding the bank rejection letter they offered in support of their damages counterclaim incompetent summary judgment evidence. The district court subsequently entered an amended judgment that, among other things, imposed personal liability on Barbara and Kevin.

On appeal, the taxpayers argued that the district court erred by not dismissing the government's claim as untimely. IRS, on the other hand, claimed that the claim was timely because the limitations period was suspended for 241 days from October 5, 2013 until June 2, 2014, the former being the postmark date on the taxpayers' request for a hearing. The taxpayers responded that §6330(e)(1) did not save IRS's claim, as the hearing process was not actually initiated until May 2014, after Kevin sent his letter to prove that IRS had received the request in October 2013.

The taxpayers also argued that IRS's motion for summary judgment attacked their §7433 counterclaim for failure to mitigate, not failure to prove damages. In general, a court may not grant summary judgment on a ground not advanced by the parties unless it gives notice and a reasonable time to respond to the party at risk of summary disposition. The district court, however, granted IRS summary judgment based on failure to prove damages, and the taxpayers argued that they lacked notice and an opportunity to adequately respond to that ground. Under Fifth Circuit precedent, summary judgment is improper if there "was no reason for the [nonmoving party] to suspect that the court was about to rule on the motion." *Kibort v. Hampton,* (CA 5 1976) 538 F.2d 90)

The Court of Appeals for the Fifth Circuit agreed with the district court that the duty of consistency barred the taxpayers from arguing that the limitations period did not begin tolling in October 2013. The Supreme Court has held that the duty of consistency applies if there is: "a representation or report by the taxpayer; (2) on which the Commission has relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the Commissioner." (*R.H. Stearns Co. v. U.S.,* (S Ct 1934) 13 AFTR 842) In this case, Kevin clearly represented to IRS that the hearing request was sent and received in October; IRS relied on that representation; and he was subsequently attempting to change that representation to IRS's detriment.

The Fifth Circuit also agreed with the district court that Kevin and Barbara were not entitled to damages under §7433 and that the district court properly granted summary judgment in IRS's favor. Although the Fifth Circuit agreed with the taxpayers that IRS's motion for summary judgment targeted their counterclaim for failure to mitigate but the court granted the motion on account of the taxpayers' failure to prove damages, it declined to vacate and remand the case because it found the error harmless. The Fifth Circuit noted that the burden was on the taxpayers to negate harmlessness by pointing to additional evidence that they would offer if given the chance on remand (*Resolution Trust Corporation v. Sharif-Munir-Davidson Dev. Corporation ,* (CA 5 1993) 992 F.2d 1398), which they failed to do.

U.S. v. Liddle, (DC CA 1/23/2017) 119 AFTR 2d ¶2017-381.

A district court has found that a CEO was liable for trust fund recovery penalty taxes for both of the companies that he ran. The CEO conceded that he was a responsible person, but argued that he acted with reasonable cause and thus did not act willfully. The court found, however, that the Ninth Circuit-to which an appeal of this case would lie-has declined to accept a reasonable cause defense, and the fact that he paid other creditors before paying the tax delinquency was sufficient to establish willfulness.

§6672 imposes a responsible person penalty on any person who: (1) is responsible for collecting, accounting for, and paying over payroll taxes; and (2) willfully fails to perform this responsibility. The amount of the penalty is equal to the amount of the tax that was not collected and paid.

In determining whether an individual is a responsible person, courts consider factors including whether the taxpayer served as an officer of the corporation or a member of its board of directors, owned a substantial amount of stock in the company, participated in day-to-day management of the company, determined which creditors to pay and when to pay them, had the ability to hire and fire employees, or possessed check writing authority. Not every factor must be present; instead, a court must consider the totality of the circumstances to determine whether the individual in question had the effective power to pay the taxes owed. There can be more than one responsible person in a business. (*Barnett,* (CA 5 1993) 71 AFTR 2d 93-1614)

Willfulness for purposes of §6672 involves a voluntary, conscious and intentional act to prefer other creditors over the U.S. (*Buffalow v. U.S.,* (CA 9 1997) 79 AFTR 2d 97-1540) Thus, if a responsible person knows that withholding taxes are delinquent, and uses corporate funds to pay other expenses, such failure to pay withholding taxes is deemed "willful." (Phillips v. IRS, (CA 9 1996) 77 AFTR 2d 96-379) There is no need to show that the responsible person had any intent to defraud the government or other bad motive, and "conduct motivated by a reasonable cause may nonetheless be willful." (*Davis v. U.S.,* (CA 9 1992) 69 AFTR 2d 92-1136)

Michael Liddle was the Chief Executive Officer (CEO) of Home Director Technologies, Inc. (HDT) from January 1, 2004 through March 31, 2005. He had authority to hire and fire employees, approve the company's payments, and determine financial policy. In his role as CEO, Liddle was provided with quarterly financial statements for the corporation, which included accrued balances such as unpaid payroll tax liabilities.

By October or November of 2004, Liddle became aware that HDT was delinquent in payment of its trust fund taxes when the company's Controller informed him that the company had not been turning over trust fund taxes to the federal government. Liddle thereafter discussed the issue with the Board of Directors and with the company's Chief Financial Officer (CFO), Daryl Stemm. The Board passed a resolution that HDT would pay its outstanding trust fund taxes and would not allow trust fund taxes to go unpaid in the future. However, HDT did not pay its delinquent or subsequent trust fund taxes. Instead, Liddle, Stemm, and other company officials made the decision to pay payroll and other operating expenses.

On August 20, 2007, Liddle consented to an extension of the statute of limitations for assessment of penalties for HDT's unpaid trust fund taxes for the tax periods ending March 31, 2004 through March 31, 2005. IRS assessed civil penalties against Liddle under §6672 for unpaid trust fund taxes of HDT for the first, second, and fourth quarters of 2004 and the first quarter of 2005.

Liddle was the CEO and the Chairman of the Board of Home Director, Inc. (HD) from January 1, 2007 through March 31, 2008. Stemm was HD's CFO. Liddle had authority to hire and fire employees, approve the company's payments, and determine financial policy. By September 30, 2007, Liddle had become aware that HD was not paying its trust fund taxes over to the federal government. HD was, however, receiving revenue and paying other corporate obligations such as payroll and travel expenses.

IRS assessed civil penalties against Liddle under §6672 for unpaid trust fund taxes of HD for the four quarters of 2007 and the first quarter of 2008. On August 12, 2009, Liddle signed an agreement consenting to an assessment of a penalty against him in the amount of $567,397 for HD's unpaid trust fund taxes for the four quarters of 2007 and the first quarter of 2008.

The U.S. filed an action in October 2014 seeking to reduce to judgment the civil penalties assessed against Liddle for the unpaid trust fund taxes of HDT and HD. Liddle conceded that he was a "responsible person" under §6672 with respect to both companies and that the trust fund taxes were not paid for the quarters in question. However, he contended that his conduct was not "willful" under §6672, stating that he acted with reasonable cause and pointing to the fact that he did not know about the unpaid obligations until after they were already delinquent. The U.S. sought summary judgment on its claims.

The district court sided with the government, finding that there was no material dispute that Liddle acted willfully. And, given that the government also established, and Liddle conceded, that he was a responsible person, the court granted the U.S. summary judgment.

The court found that Liddle's position amounted to asking the court to disregard the Ninth Circuit's articulation of the law in Davis (that conduct "motivated by a reasonable cause may nonetheless be willful") and instead rely on decisions of other circuits. For instance, the Second Circuit has recognized a reasonable cause defense to liability under §6672 where the responsible person reasonably believed that the trust fund taxes were being paid (*Winter v. U.S.*, (CA 2 1999) 84 AFTR 2d 99-6892), and the Fifth Circuit has found reasonable cause where the responsible party relief on advice of counsel (*Newsome v. U.S.,* (CA 5 1970) 26 AFTR 2d 70-5078). However, the Ninth Circuit-to which an appeal of this case would lie-has declined to find that reasonable cause can negate liability under

§6672, and has even found willfulness in a case involving reckless disregard, as opposed to actual knowledge, of whether the taxes were being paid. (*U.S. v. Leuschner*, (CA 9 1964) 14 AFTR 2d 5599)

Accordingly, looking at the undisputed facts of the case, the court found that Liddle, after learning of the trust fund tax delinquency, directed payment of payroll and other obligations other than taxes. And Liddle's claim that he did not receive an IRS notice in regard to the deficiency did not create a triable issue as to willfulness in light of the fact that he knew of the delinquency and directed payment elsewhere. The court also noted that, with respect to HD, Liddle had a duty to be "particularly vigilant" with respect to the trust fund tax obligations given the prior failure to pay trust fund taxes for HDT.

U.S. v. McGrew, (CA 9 10/17/2016) 118 AFTR 2d ¶2016-5319.

The Court of Appeals for the Ninth Circuit, affirming the district court, has held that the U.S. is entitled to foreclose its federal tax liens against a taxpayer's residence that had been community property but now belonged solely to her. The liens, which were for the tax debts of her ex-husband, arose while the residence was part of the community estate and were unaffected by its subsequent division.

Taxes are considered due and owing, and constitute a liability, as of the date the tax return for the particular period is required to be filed. (§6151(a)) For individual income tax returns made on the basis of the calendar year, that date is April 15th following the close of the calendar year. (§6072)

IRS Form 4340, Certificate of Assessments, creates a rebuttable presumption that a tax was properly assessed under §6201 and that notice and demand for payment were sent to the taxpayer as required by §6303.

A lien for unpaid tax liabilities arises in favor of the U.S. against all property and rights to property owned by the taxpayer as of the assessment date. (§6321; §6322)

The government may foreclose a tax lien against a taxpayer's interest in property upon showing that the taxpayer has an interest and that the government's tax lien has attached to it. (§7403)

Eileen McGrew and her then-husband Kenneth McGrew bought a residence in California together in 1996. They owned the residence as community property.

On or about December 20, 2004, IRS made assessments against Mr. McGrew for outstanding federal income tax liabilities for the 2000 and 2001 tax years based on substitutes for return prepared on his behalf. A similar assessment was made for the 2002 tax year on or about May 29, 2006.

Mr. McGrew filed returns for the 2000 to 2005 tax years on or about August 8. 2007. After receiving the returns, IRS abated portions of the assessments that it had made previously and made assessments for 2003 through 2005. IRS filed notices of federal tax liens with respect to the assessments on October 4, 2006, and October 22, 2007.

Ms. McGrew and Mr. McGrew separated on February 15, 2002, and their marriage was dissolved of September 14, 2006. Their community property was divided on September 28, 2009, and title to the residence was transferred to Ms. McGrew.

As of October 15, 2014, the assessments, with interest, totaled over $345,000. The government sought to foreclose its liens against the residence.

The district court found that the government was entitled to foreclose its liens. (*U.S. v. McGrew,* (DC CA 2014) 114 AFTR 2d 2014-7031)

The court first noted that Mr. McGrew's liabilities for 2000 through 2005 became due and payable on the filing deadlines for those years, even though the taxes were not assessed until later. It then concluded that the government proved the amount and propriety of the assessments with Form 4340, and that Ms. McGrew was not entitled to dispute their validity because she was not the taxpayer who owed them.

Then, the court found that, at the time that Mr. McGrew's tax liabilities were assessed (i.e., between 2004 and 2007), the U.S. acquired liens against all his property, including his community interest in the residence. California law further provides that the entire community is liable for the debts incurred by one of the spouses during the marriage, but not the debts of a spouse incurred during any period during which the spouses are living apart before the marriage is dissolved. (California Family Code §910)

Accordingly, the court concluded that the entire community estate (including the residence) was subject to Mr. McGrew's 2000 tax liability, which was incurred on April 15, 2001 before the couple separated, and that his undivided one-half interest in the community estate was subject to his liabilities for 2001 through 2005, as such were incurred after separation but before the property was divided.

Finally, the court, citing California Family Code §916(a) as well as §6321 and §6322, found that the property division had no effect on the liens. The court also found that this case was not one warranting exercise of its limited discretion to not order a foreclosure sale, noting that denying foreclosure would severely prejudice the U.S. and that there was no legal expectation that the property would be protected from a forced sale.

The Court of Appeals for the Ninth Circuit affirmed the district court's decision. The Court stated that, although the residence now belongs only to Ms. McGrew, it was part of the "community estate" liable for Mr. McGrew's debts incurred before their separation, and his half interest in the property was encumbered by the debts incurred after separation but before the property became hers alone.

Urgent Care Nurses Registry, Inc., TC Memo 2016-198.

California Corporation whose corporate charter had been suspended lacked the legal capacity to petition the Tax Court and challenge IRS's collection determination.

§6213(a) gives the Tax Court jurisdiction to redetermine a deficiency in income, estate, gift, and certain excise taxes as to which (1) a notice of deficiency pursuant to §6212(a); and (2) the taxpayer has filed a timely petition for redetermination. The taxpayer has 90 days-or 150 days if the notice is addressed to a person outside of the U.S.-from the date the notice of deficiency is mailed to file a petition in the Tax Court.

Rule 60(c) of the Tax Court Rules of Practice and Procedure provides that the capacity of a corporation to engage in litigation in the Tax Court "shall be determined by the law under which it was organized."

Urgent Care Nurses Registry, Inc. (Urgent Care) was incorporated in California on July 21, 2005, and was assigned a taxpayer identification number by the California Franchise Tax Board (board). On August 1, 2008, the board suspended Urgent Care's corporate charter pursuant to section 23301 of the Suspension and Revivor article of the California Revenue and Taxation Code, and on July 26, 2016, the California secretary of state certified that Urgent Care's "powers, rights and privileges remain suspended."

Urgent Care filed some income and employment tax returns for 2009 through 2013 but enclosed no payments. It failed to file other returns, and IRS prepared substitutes for returns and assessed all of the taxes in question plus a penalty under §6721 for failing to file Forms W-2, Wage and Tax Statement. In January of 2015, IRS sent Urgent Care a Final Notice of Intent to Levy and Notice of Your Right to a Hearing.

Urgent Care timely requested a collection due process (CDP) hearing, and a settlement officer (SO) was assigned to the case. The SO requested, and the representative submitted, a copy of Form 966, Corporate Dissolution or Liquidation, and a certificate of Urgent Care's dissolution.

A telephone CDP hearing was held on June 26, 2015, and the SO requested follow-up documentation by August 3, 2015. Having received none of the requested documentation by August 18, 2015, the SO closed the case and, on August 28, 2015, issued a notice of determination sustaining the proposed levy.

On September 28, 2015, Urgent Care timely sought review in the Tax Court. On July 28, 2016, IRS filed a motion to dismiss for lack of jurisdiction, contending that the petition was not filed by a party with capacity to sue under Rule 60(c). The Court directed Urgent Care to respond to the motion to dismiss on or before September 2, 2016, which it failed to do.

The Tax Court granted IRS's motion to dismiss for lack of jurisdiction on the ground that Urgent Care lacked legal capacity to prosecute the case.

The Court noted that under California law, the board may suspend the "powers, rights and privileges of a domestic taxpayer" if the corporation fails to pay "any tax, penalty, or interest, or any portion thereof, that is due and payable" at specified times. (Cal. Rev. & Tax §23301) Once a corporation's powers have been suspended, it may not prosecute or defend an action.

Citing *David Dung Le, M.D., Inc.,* (2000) 114 TC 268, the Court said that, accordingly, since Urgent Care's corporate powers were suspended in 2008, and there was no indication that it has since received a certificate or revivor or become current on its California tax obligations, it lacked the capacity to sue.

Whistleblower 4496-15W, (2017) 148 TC No. 19.

Where IRS does not issue a final determination letter confirming a whistleblower's award, the date that begins the 30-day period for filing a Tax Court appeal of that determination is the date on which IRS mails the whistleblower's check. It also held that the taxpayer waived his appeal rights by his checking a box on IRS's preliminary award letter that provided that his accepting of the award precluded him from filing a petition with the Tax Court.

§7623 provides for whistleblower awards. §7623(b)(4) provides: "Any determination regarding an award...may, within 30 days of such determination, be appealed to the Tax Court (and the Tax Court shall have jurisdiction with respect to such matter)."

If the IRS Whistleblower Office (Office) concludes that a whistleblower is entitled to an award, it prepares and sends him a "preliminary award recommendation." This document must notify the whistleblower that "IRS cannot determine or pay any award until there is a final determination of tax." (Regulation §301.7623-3(c)(1)) If "the whistleblower has executed an award consent form agreeing to the amount of the award and waiving the whistleblower's right to appeal the award determination," the Office "will not send...a determination letter and will make payment of the award as promptly as circumstances permit." (Regulation §301.7623-3(c)(6))

Whistleblower filed Form 211, Application for Award for Original Information. IRS collected proceeds from the target(s) identified by Whistleblower and concluded that he was entitled to an award.

On December 1, 2014, the Office mailed him a preliminary award letter. The letter provided the gross amount of the preliminarily computer award less 7.3% which IRS explained was a legally required reduction as a result of the sequester in the Budget Control Act of 2011. Whistleblower objected to the reduction, but IRS said it would not change its position

The preliminary award letter explained that Whistleblower had various options. If he agreed with the award, he was directed to "check the appropriate box, sign and date the Response to Summary Report indicating...his agreement," and "return the signed Response" to the Office. The letter explicitly informed Whistleblower that, "by checking the box that you agree with the preliminary award recommendation, you agree to waive any judicial appeal rights with respect to the award determination, including filing a petition with the U.S. Tax Court." The letter emphasized: "This letter is NOT a final determination for purposes of filing a petition with the United States Tax Court."

By letter dated December 15, 2014, Whistleblower's counsel sent the Office a Response to Summary Report accepting the award. Whistleblower signed this Response form on December 10, his counsel signed it on December 13, and the Office received it on December 30. On this Response form, Whistleblower checked the box described above.

The Office sent him a check dated January 15, 2015. On February 11, 2015, Whistleblower sought Tax Court review. He contended that the Office lacked legal support for reducing his recommended award by 7.3% on account of the sequester. IRS moved to dismiss for lack of jurisdiction.

The Court, agreeing with Whistleblower, held that the date of the "determination" referred to in §7623(b)(4) was the date that IRS sent Whistleblower the check and that therefore he met the 30-day deadline.

The Court stated that it has developed a fairly robust body of case law addressing the question of when a "determination" is made in cases where the Office declines to make an award. But, it said, it does not appear to have addressed this timing issue in a case (such as this) where the Office has notified the whistleblower that an award will be forthcoming.

The Court first noted that some of what IRS presented supported the Whistleblower's argument. IRS said that it is possible for the recommended award amount contained in a preliminary award recommendation to change, e.g., because the target taxpayer could receive a refund, reducing the amount of collected proceeds, and thereby reducing the amount of any recommended award. Thus, the award a whistleblower can expect to receive "remains subject to change until IRS makes a final award determination or issues an award payment for any agreed award."

The Court said that, as IRS acknowledged, the award that the Office proposed in its December 1, 2014 letter remained uncertain even after Whistleblower accepted it, because it was subject to conditions subsequent that could cause the award amount to be reduced.

The Court said that §7623(b)(4) is unusual as a jurisdiction-conferring provision because it does not prescribe any particular form of notice to the would-be Whistleblower. In prior cases, the Court has said that its jurisdiction is established when IRS issues a written notice that embodies a determination.

In this case, pursuant to the regulations, the Office did not issue a final determination letter confirming the amount of Whistleblower's award. The Court said that the Office issued a written notice that embodied its determination by issuing the award check and that this action notified Whistleblower of the final administrative decision.

Because Whistleblower filed his petition within 30 days of the date on which that check was mailed to him, the Court had jurisdiction.

The Court then held that Whistleblower waived his appeal rights when he sent the Response to IRS with the box checked.

With exceptions not relevant here, a settlement agreement may be reached through offer and acceptance evidenced by an exchange of letters or even in the absence of a writing. (Lamborn, TC Memo 1994-515) Under principles of contract law, the Tax Court enforces such settlements as binding agreements. Taxpayers often waive the right to seek judicial review in connection with resolution of tax disputes, and the Tax Court and other courts have regularly enforced such agreements.

Here, upon accepting the award, Whistleblower expressly waived the judicial appeal rights he would otherwise have had with respect to the Office's determination. In exchange for waiving his judicial appeal rights, Whistleblower obtained the benefit of his bargain with IRS by receiving immediate payment of the agreed-upon award. His effort to obtain the benefit of immediate payment while later seeking judicial review directly contravened the regulatory framework, which provides for payment only after all issues have been finally determined. By seeking judicial review after explicitly waiving his right to seek judicial review, Whistleblower violated his agreement with the Office.

Whistleblower made arguments that the Court rejected.

First he argued: should the Court decline to review IRS's administrative determination, the Court would deny him the only venue appropriate to review the sufficiency of the Office's decision. The Court said that this argument was unconvincing. Whistleblower had an obvious avenue for securing judicial review of the sequester reduction that the Office believed to be required. He could have disagreed with the preliminary award recommendation and submitted comments expressing his disagreement. Had he done so and had the Office stuck to its guns, he would have received a final determination letter from which he could have appealed to the Court.

He also contended the Office lacked statutory authority to implement the sequester and hence that his agreement with the Office (including the waiver) was "illegal and unenforceable."

The Court said that even if the Office were incorrect in its belief that a sequester reduction was required, this would not render the parties' agreement "illegal." When a controversy is settled, it often happens that a party has available to it a legal argument that it elects not to pursue because it desires closure in the form of an immediate settlement. That was precisely the situation here: Whistleblower could have chosen to pursue his legal theory that the Office lacked statutory authority to implement the sequester, but he chose to waive that right because he wished to receive his multi-million-dollar award immediately. He could not contend that his agreement with the Office was "illegal" on the basis of an argument that he waived the right to make,

Whistleblower 14377-16W, (2017) 148 TC No.25.

The Tax Court has rejected a serial whistleblower's motion to proceed anonymously, finding that the whistleblower's interest in protecting his anonymity was outweighed by the public's interest in knowing who is using the Tax Court to bring serial whistleblower claims.

§7623(b) provides that if IRS proceeds with any administrative or judicial action based on information brought to IRS's attention by an individual, the individual will receive a percentage of the collected proceeds as an award. Under Regulation §301.7623-2(b), IRS "proceeds based on information provided by a whistleblower" when, for example, IRS initiates a new action, expands the scope of an ongoing action, or continues to pursue an ongoing action, that IRS would not have initiated, expanded the scope of, or continued to pursue, but for the information provided.

Under §7623(a), IRS has discretionary authority to pay awards to informants (i.e., whistleblowers) in the sums it considers necessary for the detection of tax underpayments, or for the detection, trial, and punishment of tax law violators.

Under §7623(b), individuals are entitled to receive an award of 15% to 30% (or lower amounts in cases of less substantial contribution) of the collected proceeds resulting from an action based on information provided by the whistleblower in any action: (§7623(b)(5))

a. Against any taxpayer, but in the case of any individual taxpayer, only if such individual's gross income exceeds $200,000 for any tax year subject to such action, (§7623(b)(5)(A)) and

b. If the tax, penalties, interest, additions to tax, and additional amounts in dispute exceed $2 million. (§7623(b)(5)(B))

Rule 345(a) of the Tax Court Rules of Practice and Procedure concerns itself with privacy protections for filings in whistleblower actions. Petitioners in whistleblower actions are allowed to move the Court for permission to proceed anonymously. The moving party must set forth a sufficient, fact-specific basis for anonymity.

Whistleblower 14377-16W (Whistleblower), a self-described "analyst of financial institutions" moved to proceed anonymously in a whistleblower action involving his claim that a corporate taxpayer evaded paying nearly $100 million in taxes. Whistleblower feared that, if his identity as a tax whistleblower was disclosed, he would suffer both economic and personal harm.

Whistleblower learned of the corporate taxpayer's claimed tax abuse from publicly available sources, such as Securities and Exchange Commission Forms 10-K.

Whistleblower had a total of 11 cases pending before the Tax Court, involving 21 numbered whistleblower claims and as many as 50 separate taxpayers. Whistleblower also had four cases pending before IRS, involving six taxpayers.

The Tax Court concluded that Whistleblower had not made a sufficient fact-specific case for anonymity under Rule 345(a). While the Court was mindful of our legal system's general solicitude for confidential informants, it found that, on balance, Whistleblower's interest in protecting his anonymity was outweighed by the public's interest in identifying serial claimants of whistleblower awards filing petitions in the Tax Court.

The Court noted that in only five cases had the Court addressed a whistleblower's motion to proceed anonymously. Unlike the claimants in three of the cases, Whistleblower made no plausible claim that he was (or might be) threatened physically. Nor did he claim an employee relationship during which he was privy to internal deliberations and communications regarding the possible underpayment of tax, the revelation of which circumstances would likely severely damage a whistleblower's professional standing in the community in which he customarily earned his living and could well jeopardize his employment. And Whistleblower was at no risk of the loss of employment-related benefits, such as retirement benefits.

Unlike the claimants in the five cases, Whistleblower had not identified a taxpayer who, upon learning his identity, would have the power to, and might be expected to, act against him. And while the Court accepted that Whistleblower might suffer some embarrassment or annoyance from the Court's denying the motion, his fears of marital discord, the alienation of unnamed business partners, and retribution from unnamed political figures were speculative, and, thus, he had not provided the Court with a sufficient "fact-specific" justification for permission to proceed anonymously.

While the Court might otherwise be inclined to weigh the public's interest in knowing who is using the courts as so weak as to give Whistleblower the benefit of the doubt, at least temporarily, the Court, noting his prolific whistleblower activity, found that Whistleblower was an unusual claimant to the Court's whistleblower jurisdiction. Whistleblower's recourse to publicly available materials to identify supposed tax abuses imposed no natural limit other than his own industriousness on the number of cases he could bring. His lack of an employment or other close relationship to the taxpayers he identified suggested that he had no familiarity with a taxpayer's basis or rationale for taking what Whistleblower considers an abusive position. For these reasons, serial claimants of whistleblower awards-such as Whistleblower-may disproportionately burden the Court with petitions only superficially meritorious.

The Tax Court said that the phenomena of potential claimants of whistleblower awards searching publicly available documents for evidence of tax abuse was not insignificant. Apparently, a cottage industry has sprung up involving mining publicly available documents for the chance to claim a bounty from IRS. Unless the Court identifies serial filers by name, the public will be unable to judge accurately the extent to which the serial filer phenomenon has affected the work of the Tax Court because the public would not know whether any particular petitioner of an adverse whistleblower determination had filed petitions appealing other adverse whistleblower determinations.

Finally, the Court stated that addressing motions by all whistleblowers to proceed anonymously requires special handling by the Court. For example, the record is sealed temporarily, the normal procedures for electronic filing and electronic service cannot at this time be used, the case must be assigned to a judicial officer earlier than normal in order to address the motion, and, in some cases, trials and hearing may need to be closed to the public to protect the whistleblower's anonymity. The public may wish to know the extent to which petitioners with numerous whistleblower claims require such special handling.

The Court also noted that, although IRS has obligated itself to use its best efforts to protect the identity of whistleblowers, that obligation is not absolute, and, in some circumstances, IRS may need to reveal a whistleblower's identity (for example, if the whistleblower is to be called as a witness in a judicial proceeding). The risk to a whistleblower that he will not remain anonymous is present from the time he submits a whistleblower claim to IRS.

Whitesell, TC Memo 2017-84.

The Tax Court has held, for a number of reasons, that IRS did not accept the taxpayers' offer in compromise (OIC) when it cashed their check that accompanied the OIC and then, approximately 100 days later, refunded the taxpayers' payment. The Court also held that, where a taxpayer is a shareholder in an S corporation, the statute of limitations on assessment with respect to the taxpayer is based on the date of filing of the taxpayer's return, not the S corporation's return.

IRS is authorized to compromise a taxpayer's income tax liability (via an OIC) under §7122(a).

An OIC is deemed to be accepted by IRS if IRS does not reject it within 24 months after the offer is submitted. (§7122(f))

"Accord and satisfaction" is a contract law concept. It describes an agreement to accept less than is legally due in order to wrap up the matter. Once the accord and satisfaction is made and the amount paid (even though it is less than owed), the debt is wiped out because the new agreement (accord) and payment (the satisfaction) replaces the original obligation.

With exceptions not relevant here, a valid assessment of income tax liability may not be made more than three years after the later of the date the tax return was filed or the due date of the tax return. For purposes of this rule, a "return" is the return required to be filed by the taxpayer (and does not include a return of any person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit). (§6501(a))

The taxpayers were Mr. and Mrs. Whitesell, who, for the years at issue, 2011 and 2012, filed joint returns.

IRS assessed deficiencies for the taxpayers' 2011 and 2012 tax years, which, including penalties, totaled about $3.5 million. Their returns for the two years included income from S corporations whose returns were filed months before the Whitesells' returns for those years were filed.

The Whitesells disputed that IRS's assessments were made within the §6501(a) statute of limitations and petitioned the Tax Court in October 2015.

On December 28, 2015, after their petition was filed with the Court, the Whitesells mailed to IRS a modified Form 656-L, Offer in Compromise (Doubt as to Liability), for their Federal income tax liabilities, including liabilities resulting from the S corporations. The Whitesells substantially modified the terms and conditions of the Form 656-L by crossing out sentences in subsections (b) and (d) and crossing out entirely subsections (k), (l), and (m). Along with their OIC, the Whitesells tendered a $3 million check as satisfaction of their tax liabilities.

IRS received their OIC and deposited the $3 million check. A few weeks later, on January 21, 2016, IRS sent the Whitesells a letter informing them that it was returning their OIC. On February 9, 2016, IRS sent the Whitesells another letter confirming that it had closed its file on their OIC and was in the process of refunding their $3 million deposit because of the modified terms and conditions. The Whitesells received the refund and deposited it on April 8, 2016.

The Whitesells argued that under the Uniform Commercial Code (UCC), their OIC was accepted when IRS negotiated the check and did not reject their OIC within 90 days of receipt. IRS argued that negotiation of a check does not constitute accord and satisfaction and that the UCC does not govern the power of IRS to administer the Federal income taxation system. The Court fully agreed with IRS.

The Court said that voluntary settlement of civil controversies is in high judicial favor. The Tax Court has historically declined to set aside a settlement duly executed by the parties and filed with the Court in the absence of fraud or mutual mistake. However, a court will not force a settlement on parties where no settlement was intended.

A settlement is a contract and, consequently, general principles of contract law determine whether a settlement has been reached. A prerequisite to the formation of a contract is an objective manifestation of mutual assent to its essential terms.

In order for it to determine that the parties entered into a valid settlement, the Court said, it had to determine as a prerequisite whether the parties objectively manifested mutual assent to settle the Whitesells' income tax liabilities. Depending on the facts and circumstances of a case, mutual assent can be objectively manifested by concessions, compromises, and settlements and can be memorialized in various ways, including the parties' execution of a stipulation of settled issues or a stipulation of settlement. In addition, a settlement agreement may be reached through offer and acceptance made by letter or even in the absence of writing.

The Court said that the parties did not file with the Court any document memorializing settlement of the issues, nor did the parties manifest mutual assent through an offer and acceptance. The Whitesells argued that their submission of the OIC with the $3 million check, together with IRS's negotiation of the check, constituted an accord and satisfaction under the UCC and thus met the mutual assent requirement for a contract. However, the Court said, the U.S. Government, as the sovereign, is not bound by such State statutes as the UCC. (*Burnet v. Harmel,* (S Ct 1932) 11 AFTR 1085; *Texas Learning Tech. Group,* (1991) 96 TC 686)

In any event, the Whitesells' submission of the OIC on December 28, 2015, did not illustrate IRS' assent. By letter dated January 21, 2016, IRS notified the Whitesells that their OIC would be returned along with their $3 million deposit. IRS also notified the Whitesells in a second letter dated February 9, 2016, that the reason for rejecting the OIC was the Whitesells' modifying its terms and conditions. Under a contract law analysis, IRS rejected the Whitesells' offer; thus, there was no settlement.

The Whitesells further argued that by cashing their check, IRS accepted their OIC. The Court said that this argument was incorrect. IRS cashing a check does not necessarily mean that IRS has accepted the offer. Additionally, the Whitesells understood at the time they submitted their OIC that their payment could be returned. Their modified Form 656-L, the Whitesells offered to pay $3 million and hand wrote "pursuant to section 4 Terms - 4b." Section 4(b) of the Terms states: "If IRS rejects or returns the offer...IRS will return any amount paid with the offer."

Under IRS guidelines for OICs, payments or deposits received with the OIC are either placed in a non-interest-bearing account, stamped nonnegotiable and returned, or posted to a taxpayer's account. (Internal Revenue Manual (IRM) pt. 5.8.2.8) Once a determination has been made with respect to an OIC, deposits on accepted OICs will be applied against the taxpayer's liability, and deposits on withdrawn, rejected, or returned offers will be refunded to the taxpayer. (IRM pt. 5.19.7.2.12.3) IRS rejected the Whitesells' OIC and subsequently returned their $3 million deposit in accordance with those guidelines.

Alternatively, the Whitesells argued, their OIC was deemed accepted under the UCC because their offer was not rejected within 90 days. The Court rejected this argument because IRS's rejection was timely under §7122(f) and because, as noted above, IRS is not bound by State statutes such as the UCC.

The Court held that the controlling return for purposes of the period of limitation for assessment was the Whitesells' respective Forms 1040-not the corresponding Forms 1120S of the S corporations. The Court looked to both the language of §6501(a) itself and the legislative history behind that language; the latter provided that the definition of "return" in §6501(a) is intended to clarify that the return that starts the running of the period of limitations on assessment for a taxpayer is the return of the taxpayer and not the return of another "person" from whom the taxpayer has received an item of income, gain, loss, deduction, or credit. (H.R. Rept. No. 105-148 (1997))

Whitsett, TC Memo 2017-100.

Despite the fact that her tax return preparer made numerous mistakes with respect to the preparation and filing of her tax returns, the taxpayer's actions, including her reliance on the preparer, were reasonable and in good faith. As a result, the Court found that she was not subject to an accuracy-related penalty.

Under §6664(c)(1), an accuracy-related penalty under §6662 will generally not apply to any portion of an underpayment if it is shown that there was reasonable cause for that portion and that the taxpayer acted in good faith. Reasonable cause requires that the taxpayer exercise ordinary business care and prudence as to the disputed item. (*Neonatology Associates,* (2000) 115 TC 43, aff'd (CA 3 2002) 90 AFTR 2d 2002-5442). Good faith means, among other things, an honest belief and an intent to perform all lawful obligations. (*Hirschfeld,* (CA 4 1992) 70 AFTR 2d 92-5697)

Both of those defenses can potentially be established by, among other things, reliance on the advice of a tax professional. (*U.S. v. Boyle,* (S Ct 1985) 55 AFTR 2d 85-1535)

A taxpayer claiming reliance on a tax professional must prove that: (1) the adviser was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer provided necessary and accurate information to the adviser; and (3) the taxpayer actually relied in good faith on the adviser's judgment. (Neonatology)

The taxpayer, Ms. Whitsett, was a medical doctor.

She owned stock in Immucor. In July 2011, TPG made an offer to Immucor's shareholders to purchase their stock for $27 per share. Whitsett accepted the offer, and on December 21, 2011, she completed and submitted the required stock redemption form. In January 2012, TPG's agent, Computershare, sent Whitsett a check, dated January 4, 2012, for $1,717,038 (63,594 shares × $27 per share). This check was accompanied by a document captioned "Corporate Action Advice" that showed the "payment date" as August 19, 2011, and the "tax year" as 2012. Computershare also enclosed a letter dated January 9, 2012, stating that Whitsett's stock redemption was "processed" as of January 4, 2012.

In January, 2012, Whitsett brought to the attention of her return preparer, Mr. Whittemore, the documents she had received from Computershare. Whittemore had been her preparer for many years and had been preparing 100 to 125 returns per year for clients for the last 25 years, primarily for dentists and doctors.

After speaking with Whitsett and reviewing the documents she provided, Whittemore decided (erroneously) that 2011 was the proper tax year for which to report her gain from the sale of the Immucor stock. To determine her gain, he first subtracted from the sale proceeds her original cost basis of $11,000, which he obtained by calling a stockbroker to obtain the average selling price for the Immucor stock on the purchase date. He then subtracted what he thought were reinvested dividends of $628,437, but this amount was greatly overstated.

Whittemore could not complete Whitsett's 2011 return on time, so he prepared an extension and mailed it to IRS. Thereafter, he had Whitsett pay what he believed was her 2011 tax liability, the bulk of which was his estimate of the tax on her Immucor gain.

Whittemore did not file Whitsett's 2011 return by the extended due date, October 15, 2012. On February 19, 2013, he sent her a letter accompanied by a completed copy of her 2011 return. Whittemore sent Whitsett an email concurrently with the completed 2011 return, stating that he had "filed the return electronically."

Whittemore did not file Whitsett's 2011 return. IRS had no record of ever having received that return. Whittemore could not produce any document to verify successful efiling of the return. Nor could he produce any document (such as a "bounce back" message) evidencing that he had attempted an efiling that IRS rejected.

Unaware of these facts, Whitsett retained Whittemore to prepare her 2012 return. Whittemore again prepared, and she submitted to IRS, a Form 4868 requesting an automatic extension of time to file. Whittemore sent her a 2012 tax information organizer sometime during the first half of 2013. She filled it out, enclosed the documents called for, and returned the organizer to Whittemore. She enclosed a letter noting her belief that she had sold the Immucor stock in 2011.

Sometime in early 2013, Computershare sent Whitsett a 2012 Form 1099-B, Proceeds From Broker and Barter Exchange Transactions, for the Immucor sale. Whittemore determined that no capital gain attributable to the Immucor stock sale needed to be reported on Whitsett's 2012 return because he had already reported (or thought he had reported) that income on her 2011 return. He accordingly did not include a Schedule D, Capital Gains and Losses, with the 2012 return, which he filed late.

IRS determined a 2012 deficiency and an accuracy-related penalty. Whitsett brought suit in Tax Court; after a settlement of the deficiency issue, the only issue before the Court was the accuracy-related penalty.

The Court held that Whitsett acted with reasonable cause and in good faith.

The Court first considered Whitsett's conduct before her reliance on Whittemore, to determine whether she exercised "ordinary business care and prudence." In contending that she did not, IRS relied principally on the documents she received from Computershare in January 2012. Those documents included a check dated January 4, 2012; a letter stating that the redemption was "processed" on that same date; and a "Corporate Action Advice" stating that the "tax year" was 2012 and that the "payment date" was August 19, 2011. IRS contended that a person exercising "ordinary business care and prudence" would have understood from these documents that any gain from the Immucor stock sale would be properly reportable on a tax return for 2012.

The Court disagreed. Although Whitsett was a highly educated person and a skilled physician, she had no knowledge of Federal income taxation. She had tendered her stock to Immucor for redemption in December 2011. Although the documents she received in January 2012 said that her redemption was "processed" on January 4 and that the "tax year" was 2012, they also stated that the "payment date" was August 19, 2011. As a lay person unfamiliar with tax law and stock redemptions, Whitsett understandably found this documentation confusing and reasonably referred this question to her longtime tax return preparer.

Whitsett precisely followed all of Whittemore's instructions; she forwarded all relevant tax documents to him for his review and evaluation; she sent tax payments to IRS as he told her to do; and she timely replied to communications she received from IRS (while laboring under the justifiable but mistaken belief that he had filed her 2011 return electronically).

The Court said that, given the time value of money, it would have been in Whitsett's economic interest to report her million-dollar gain on a 2012 return rather than on a 2011 return. She displayed admirable "business care and prudence" by referring this question to Whittemore and accepting his advice to report the gain for 2011, rather than deciding unilaterally what would be best for her pocketbook

Evaluating her conduct as a whole, the Court said, it had no doubt that she exercised "ordinary business care and prudence."

The Court then looked at the Neonatology factors. As to the first factor, the Court noted that Whittemore had a well-established tax return preparation business; he specialized in preparing returns for physicians such as Whitsett; and he had prepared returns for Whitsett and her ex-husband for many years with no IRS challenge apart from an occasional math error.

IRS argued that this Neonatology factor did not apply because of all of the errors that Whittemore committed. But, the Court said, whenever a taxpayer advances a "reliance on professional advice" defense against an accuracy-related penalty, the adviser will have made one or more mistakes. If the taxpayer is completely unaware of the adviser's errors, as was true here, those errors cannot be used retroactively to demonstrate the adviser's lack of competence. The Court found that Whitsett demonstrated Whittemore's competence by reason of his knowledge and experience in preparing tax returns and that she was justified in relying on him.

As to the second Neonatology factor, the Court concluded that Whitsett provided Whittemore with all of the facts and documents necessary for him to determine the proper tax year for reporting her gain on the sale of the Immucor stock. She forwarded all of the documentation she had received from Computershare in January 2012. In October 2013, she provided him with her 2012 tax organizer and specifically brought the Immucor stock sale to his attention, noting her recollection that this sale had been reported for 2011. After reviewing this information, he determined that the Immucor sale proceeds should not be reported for 2012 because (he thought) those sale proceeds had already been reported for 2011. Whitsett could not be blamed for this erroneous decision.

As to the third factor, the Court said that Whitsett was a medical doctor with no training in tax return preparation or corporate law. She had retained Whittemore to prepare her returns for many years, and none of those prior returns had prompted a serious IRS challenge. Whitsett indisputably relied on Whittemore's judgment that the Immucor sale proceeds should be reported for 2011 rather than 2012. And her reliance clearly displayed good faith. The documentation Computershare furnished was confusing to a lay person, and Whitsett reasonably referred the timing question to him.

And, the Court said, this was not a case where the adviser's judgment about the recommended tax treatment was "too good to be true." Quite the contrary: Whittemore's advice went against Whitsett's economic interest, but she nevertheless accepted it. "In our view, this constitutes proof positive of her good faith."

W. Zintl Construction Inc., TC Memo 2017-119.

The Tax Court has clarified two aspects of the use of a business's going concern value when IRS considers whether to accept a taxpayer's offer in compromise (OIC).

§6320(a)(1) and §6330(a)(1) require IRS to give a taxpayer written notice when a Federal tax lien is filed upon the taxpayer's property or IRS intends to levy upon the taxpayer's property. The notice must inform the taxpayer of the right to request a collection due process (CDP) hearing in the Appeals Office. If a taxpayer makes a timely written request and states the grounds for the requested hearing, the taxpayer is entitled to a fair hearing conducted by an impartial officer from the Appeals Office. (§6320(a)(3)(B), §6330(a)(3)(B))

Following the hearing, the Appeals officer conducting the hearing must determine whether the collection action is to proceed, taking into account, among other things, whether the collection action balances the need for the efficient collection of taxes with the legitimate concern of the taxpayer that any collection action be no more intrusive than necessary. (§6330(c)(3)) Other relevant issues to be considered may include challenges to the appropriateness of the collection actions and potential collection alternatives such as an installment agreement or OIC.

IRS is authorized to compromise a taxpayer's income tax liability under §7122(a), which gives it wide discretion to accept compromise offers and to prescribe guidelines to determine the adequacy of an offer. One of the grounds for the compromise of a tax liability is doubt as to collectability (Regulation

§301.7122-1(b)), which "exists in any case where the taxpayer's assets and income are less than the full amount of the liability." (Regulation §301.7122-1(b)(2))

IRS will accept an OIC based on doubt as to collectability when it's unlikely that it can collect the unpaid tax liability in full and the offer reflects the taxpayer's reasonable collection potential (RCP)- i.e., the amount that IRS thinks it can get from the taxpayer's assets and income. (Internal Revenue Manual (IRM) pt. 5.8.4.3)

IRM pt. 5.8.5.17 states, as relevant:

1. Evaluation of a business as a going concern is sometimes necessary when determining RCP of an operating business owned individually or by a corporation, partnership, or LLC. This analysis recognizes that a business may be worth more than the sum of its parts, when sold as a going concern.

2. To determine the value of a business as a going concern consider the value of assets, future income, and intangible assets such as: ability or reputation of a professional; established customer base...

3. Generally, the value of a business as a going concern would not be included in RCP of a viable, ongoing business, unless the value is substantially greater than the income produced by the business.

Where there is no dispute as to the taxpayer's underlying liabilities, the Tax Court reviews the Appeals Office's determination for abuse of discretion. (*Goza,* (2000) 114 TC 176) An abuse of discretion exists when a determination is arbitrary, capricious, or without sound basis in fact or law. The Court does not substitute its judgment for that of the IRS settlement officer (SO) as to the acceptability of a particular offer. If the SO follows all statutory and administrative guidelines and provides a reasoned, balanced decision, the Court will not reweigh the equities. Veneziano, TC Memo 2011-160, provides that, generally, the SO does not abuse his or her discretion by rejecting an offer in compromise in accordance with the guidelines set forth in the IRM.

The taxpayer was W. Zintl Construction, Inc. (Construction), a construction subcontractor. Construction owed $3.7 million of unpaid payroll taxes; with interest and penalty, the total owed was $6.6 million. IRS sent Construction notices of intent to levy. Construction promptly submitted requests for a CDP hearing on which it checked "offer in compromise" as a collection alternative.

Construction made an OIC of $1 million. In support thereof, Construction provided a profit and loss statement, a balance sheet and a "Summary Appraisal Report" indicating a "Forced Liquidation Value" for Construction's machinery and equipment of $1,155,000.

SO Albright requested additional documentation, including a valuation of the business as a going concern. Construction employed an appraiser and provided the requested information. The appraisal estimated a going concern fair market value of $2,100,000, using three valuation methods, each of which subtracted accrued the payroll tax liability and interest of $4,190,980. The appraisal also estimated a liquidation value for the company of negative $3,720,000.

In a letter to Construction dated April 24, 2014, SO Albright said: "The appraisal estimated the value of the business to be $2,100,000 after allowing for the IRS debt of $4,190,980. In other words, the value of the business for purposes of the OIC is estimated to be $6,290,980. In determining the reasonable collection potential in an OIC, IRS would generally reduce the asset values by 20%. As a result, in this case the reasonable collection potential is computed to be $5,032,784 ($6,290,890 x.8)."

SO Albright gave Construction an opportunity to submit an amended OIC "in an amount at least equal to the reasonable collection potential" and stated that he likely would reject the original $1 million offer if an amended offer were not received by May 8, 2014. By letter dated May 1, 2014, Construction disagreed with the "use of the going concern valuation of Zintl to calculate an acceptable offer in compromise amount," stating that going concern value applies only when the taxpayer is the owner of a business; it cannot apply when the taxpayer is the business.

On June 17, 2014, SO Albright issued Construction a letter stating that he had "been unable to find anything to indicate that the going concern value cannot be used in determining the RCP when the taxpayer is a business (as opposed to when the taxpayer is the shareholder of a business)." He advised Construction that if it wanted to amend the OIC to reflect the computed RCP of $5,032,784 it should submit an amended Form 656 by July 1, 2014. Construction advised Albright that it was unable to secure financing to fund a $5 million OIC but was continuing to work with banks on financing. On August 4, 2014, Construction's attorney notified Albright that Construction anticipated receiving a loan of $3 million that if approved would allow Construction to increase its OIC to $3,200,000. Albright noted, among other concerns, that the deadline for increasing the OIC had lapsed and the loan had not yet been approved.

On August 11, 2014, IRS issued a notice of determination that rejected Construction's offer of $1 million because its RCP exceeded that amount; IRS sustained the disputed collection actions. Construction challenged the determination in Tax Court.

The issues. 1) Whether the SO abused his discretion by using the going concern value as described in IRM pt. 5.8.5.17. 2) Whether the SO's calculation of RCP was reasonable.

Construction contended that the going concern valuation method in IRM pt. 5.8.5.17 applies only when the taxpayer is the owner of a business; it cannot apply when the taxpayer is the business. Construction said that this was the case because IRS "can never collect the going concern value by levying and seizing all the assets from the taxpayer." Construction further argued that if the IRM provision allows IRS to use the going concern valuation method to determine Construction's RCP, then the IRM provision itself "is an abuse of discretion by IRS." IRS contended that there is "nothing prohibiting IRS from selling the business off as a going concern after seizing it."

The Court said that, in effect, Construction asked the Court to decide that use of the going concern value of a business is never appropriate when the business being valued is the taxpayer. The Court responded, "We cannot so conclude, nor need we, because we find that SO Albright's calculation of RCP was faulty for a different reason."

The Court then held that the SO's calculation of the going concern value was not reasonable.

In calculating Construction's RCP, SO Albright increased Construction's going concern value by the amount of the unpaid tax liability that the appraisal took into account in its calculation of value and based his determination of RCP solely on this modified value. The Court said that this modification to the value seems logical at first blush. Reducing Construction's going concern value by its tax liability when determining how much of this tax liability Construction can pay would seem to double count the tax liability and provide a boon to a business taxpayer whose tax debt is part of the business being valued. It is this tax liability that will be satisfied with the OIC, after all.

The Court said that the problem is that the going concern value is intended to give some indication of the value of Construction as a continuing business, that is, what a third party might pay to buy Construction as a whole, including all of its assets and liabilities. No third party would buy Construction without taking into account the unpaid tax liability. And the record showed that

Construction could not obtain financing for the modified amount either. This highlighted the logical difficulty of using going concern value - which presumes that a taxpayer can sell itself - to determine RCP.

The Court concluded that SO Albright's rejection of Construction's OIC solely on the basis of his calculation of RCP that used Construction's going concern valuation but disregarded completely its tax liability was not reasonable. Accordingly, it remanded the case to IRS's Office of Appeals for the purpose of having it determine Construction's RCP. The Court also said that it could not conclude that consideration of the going concern value and the information in the appraisal were irrelevant or that the new SO may not consider this information, including the specific assets and liabilities (including the tax liability), on remand. And, it said, it was not holding that Construction's offer was reasonable.

T.D. 9821, 07/18/2017, Regulation §1.1446-3T, Regulation §1.6012-6T, Regulation §1.6031(a)-1T, Regulation §1.6032-1T, Regulation §1.6033-2T, Regulation §1.6041-2T, Regulation §1.6041-6T, Regulation §1.6072-2T, Regulation §1.6081-1T, Regulation §1.6081-2T, Regulation §1.6081-3T, Regulation §1.6081-5T, Regulation §1.6081-6T, Regulation §1.6081-9T, Regulation §31.6071(a)-1T, Preamble to Proposed Regulation 07/18/2017.

Final and temporary regulations that update the due dates and the rules for extensions of time to file certain tax returns and information returns; the regulations reflect the statutory requirements set by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (Surface Transportation Act, PL 114-410) and the Protecting Americans from Tax Hikes Act of 2015 (PATH, PL 114-113). The text of the temporary regulations also serves as the text of contemporaneously issued proposed regulations.

The Surface Transportation Act included a major restructuring of entity return due dates, effective generally for returns for tax years beginning after December 31, 2015. The Surface Transportation Act provided that:

a. A partnership return-Form 1065 (U.S. Return of Partnership Income)-has to be filed by the 15th day of the 3rd month after the end of the tax year (rather than by 15th day of the 4th month after the end of the tax year). Thus, partnerships with a calendar year have to file by March 15 of the following year. (§6072(b), as amended by Surface Transportation Act §2006(a))

b. Returns of C corporations (most forms in the Form 1120 series) have to be filed by the 15th day of the 4th month after the end of the tax year (rather than by the 15th day of the 3rd month after the end of the tax year). Thus, C corporations with a calendar year will have to file by April 15 of the following year. However, for returns of C corporations with fiscal years ending on June 30, this change will not apply until tax years beginning after December 31, 2025. (Surface Transportation Act §2006(a)(3))

Effective for returns for tax years beginning after December 31, 2015, Surface Transportation Act §2006(b) directed IRS to modify its regulations to provide that the maximum extension for:

a. The returns of partnerships filing Form 1065 is a 6-month period ending on September 15 for calendar year taxpayers (rather than a 5-month period);

b. The returns of trusts filing Form 1041 (U.S. Income Tax Return for Estates and Trusts) is a 5 ½-month period ending on September 30 for calendar year taxpayers; (rather than a 5-month period);

c. The returns of organizations exempt from income tax filing Form 990 (series) is an automatic 6-month period ending on November 15 for calendar year filers (rather than a 3-month period);

d. The returns of organizations exempt from income tax that are required to file Form 4720 returns of excise taxes is an automatic 6-month period beginning on the due date for filing the return, without regard to any extensions (rather than a 3-month period)

e. The returns of trusts required to file Form 5227 (Split-Interest Trust Information Return) is an automatic 6-month period beginning on the due date for filing the return, without regard to any extensions (rather than a 3-month period);

f. The filing of Form 6069 (Return of Excise Tax on Excess Contributions to Black Lung Benefit Trust Under Section 4953 and Computation of Section 192 Deduction) is an automatic 6-month period beginning on the due date for filing the return, without regard to any extensions (rather than a 3-month period); and

g. A taxpayer required to file Form 8870 (Information Return for Transfers Associated With Certain Personal Benefit Contracts) is an automatic 6-month period beginning on the due date for filing the return, without regard to any extensions (rather than a 3-month period).

The PATH Act accelerated the due dates for returns and statements relating to employee wage information and nonemployee compensation. Effective for returns and statements relating to calendar years after December 18, 2015 (e.g., filed in 2017), the PATH Act requires forms W-2, W-3, and returns to report non-employee compensation (e.g., Form 1099-MISC), to be filed on or before January 31 of the year following the calendar year to which such returns relate (rather than (a) for paper forms in the Form W-2 series, Form W-3, and Form 1099-MISC, either February 28 or the last day of February of the calendar year following the calendar year for which the information was being reported; or (b) for filing these information returns electronically, March 31 of the calendar year following the calendar year for which the information was being reported.) These returns are no longer eligible for the extended filing date for electronically filed returns. (§6071(c), as amended by PATH Act §201(a))

IRS has now issued final, temporary, and proposed regulations that update the due dates and extensions of time to file certain tax returns and information returns to reflect changes made by the Surface Transportation Act and the PATH Act.

Regulation §1.6072-2T provides that, except in the case of a C corporation that has a tax year that ends on June 30, the last date for filing the income tax return of a C corporation is the fifteenth day of the fourth month following the close of the tax year.

Regulation §1.6081-3T provides a 7-month automatic extension of time to file the income tax return of any C corporation with a tax year that ends on June 30 and before January 1, 2026. The temporary regulations provide a 6-month automatic extension of time to file a return for all corporations, except for C corporations that have a tax year that ends on June 30 and before January 1, 2026.

The return for a short period that ends on any day in June is treated as if it is the return for a tax year ending on June 30 for purposes of the last date for filing the income tax return of a C corporation under Regulation §1.6072-2 and the duration of the extension of time to file the income tax return of a C corporation under Regulation §1.6081-3. (Regulation §1.6072-2T(a)(2), Regulation §1.6081-3T(e))

Regulation §1.6081-2T provides that partnerships may obtain an automatic 6-month extension of time to file Form 1065 and Form 8804 (Annual Return for Partnership Withholding Tax (Section 1446)) if the partnership files an application in accordance with Regulation §1.6081-2(b).

Regulation §1.6081-6(a)(1) provides an automatic 5-month extension of time for a non-bankruptcy estate or a trust to file Form 1041 (U.S. Income Tax Return for Estates and Trusts), if the estate or trust files an application in accordance with Regulation §1.6081-6(b). Regulation §1.6081-6T(a)(1) provides both non-bankruptcy estates and trusts an automatic 5 ½-month extension of time to file a Form 1041, if that the estate or trust files an application in accordance with Regulation §1.6081-6(b). IRS notes that these regulations do not amend Regulation §1.6081-6(a)(2), which addresses bankruptcy estates filing Form 1041.

Exempt organizations. Regulation §1.6081-9T provides an automatic 6-month extension of time to file the following forms if the exempt organization files an application in accordance with Regulation §1.6081-9(b).

1. Form 990 (Return of Organization Exempt From Income Tax

2. Form 990-BL (Information and Initial Excise Tax Return for Black Lung Benefit Trusts and Certain Related Persons);

3. Form 990-EZ (Short Form Return of Organization Exempt From Income Tax);

4. Form 990-PF (Return of Private Foundation);

5. Form 990-T (Exempt Organization Business Tax Return);

6. Form 4720 (Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code);

7. Form 5227 (Split-Interest Trust Information Return);

8. Form 6069 (Return of Excise Tax on Excess Contributions to Black Lung Benefit Trust Under Section 4953 and Computation of Section 192 Deduction); and

9. Form 8870 (Information Return for Transfers Associated With Certain Personal Benefit Contracts).

For administrative convenience and to provide filers of Form 1120-POL (U.S. Tax Return for Certain Political Organizations) with an automatic extension of time to file that is consistent with the automatic extension of time to file applicable to other exempt organization returns identified above, the automatic extension of time to file Form 1120-POL is removed from the forms eligible for an extension of time to file under Regulation §1.6081-3 and added to the forms eligible for a 6-month extension of time to file under Regulation §1.6081-9T. (Regulation §1.6081-3T(f))

Regulation §1.1446-3(b)(2)(v)(C) is revised to update the period of underpayment for the §1446 withholding tax: the period of underpayment of estimated tax by a corporation under §6655 for the §1446 withholding tax described in Regulation §1.1446-3(b)(2)(v)(C) is administratively tied to the due date of Form 8804.

Regulation §1.6032-1 is revised to clarify that the due date for returns of banks with respect to common trust funds, commonly filed on Form 1065, has changed; the due date for these returns is administratively tied to the due date of Form 1065.

Regulation §1.6033-2(e) is revised to clarify that the due date for the annual return filed by a religious or apostolic association or corporation on Form 1065 has changed; these returns are to be filed on the due date of a partnership return under §6072(b).

IRS notes that the filing date changes enacted by the Surface Transportation Act also indirectly affect various due dates and extended due dates that, although determined by §6072, are often specified throughout the regulations by cross-reference to, or by restating the dates in, former §6072 prior to amendment by the Surface Transportation Act. Because IRS must prioritize limited resources, these regulations generally do not make amendments to update, conform, or clarify the due dates and extended due dates referenced in such regulation sections. To the extent that any existing regulations (including examples) are not consistent with the due dates specified by §6072 (as amended), the statutory due dates control. If resources permit, IRS will update outdated examples and regulatory text through future guidance projects. In the meantime, taxpayers should refer to the relevant form instructions for guidance.

These regulations are generally applicable for returns filed on or after July 20, 2017. However, many of the amendments in these regulations reflect statutory changes that were effective for tax years beginning after December 31, 2015, and those statutory changes supersede regulations that are amended by T.D. 9821, 07/18/2017.

In addition, taxpayers may elect to apply these regulations to returns filed for periods beginning after December 31, 2015. The election is made by filing a return by the due date or extended due date specified in these regulations if that due date is later than the due date specified by regulations in effect at the time the return is filed.

T.D. 9799, 12/02/2016, Regulation §1.6695-2T, Preamble to Proposed Regulation 12/02/2016, Proposed Regulation §1.6695-2.

Temporary regulations that implement recent law changes that expand the tax return preparer due diligence penalty under §6695(g) so that, in addition to the earned income credit (EIC), it applies to the child tax credit (CTC), the additional child tax credit (ACTC), and the American Opportunity Tax Credit (AOTC). The regulations also reflect that the penalty is adjusted for inflation. The text of the temporary regulations also serves as the text of the proposed regulations.

Prior to recent amendments , §6695(g) imposed a penalty on an income tax return preparer who failed to meet the EIC due diligence requirements set out in regs

Former Regulation §1.6695-2 implemented §6695(g) by imposing due diligence requirements on persons who were tax return preparers under §7701(a)(36) with respect to determining eligibility for, or the amount of, the EIC.

Under the due diligence requirements set out in the regulations, a preparer must:

1. Complete and submit Form 8867, "Paid Preparer's Earned Income Credit Checklist" (as the form was termed prior to its revision);

2. Complete the Earned Income Credit Worksheet (Worksheet), as contained in the Form 1040 instructions or record the preparer's computation of the credit, including the method and information used to make the computation;

3. Not know or have reason to know that any information used by the preparer in determining eligibility for, and the amount of, the EIC is incorrect and make reasonable inquiries when

required, documenting those inquiries and responses contemporaneously (knowledge requirement); and

4. Retain, for three years from the applicable date, the Form 8867, the Worksheet (or alternative records), and the record of how and when the information used to determine eligibility for, and the amount of, the EIC was obtained by the preparer, including the identity of any person furnishing information and a copy of any document relied on by the preparer.

To comply with the knowledge requirement under Former Regulation §1.6695-2(b)(3), the tax return preparer may not ignore the implications of information furnished to or known by him, and must make reasonable inquiries if the information furnished to him appears to be incorrect, inconsistent, or incomplete. Examples in the regulations illustrate this requirement.

A tax return preparer is required to submit the Form 8867 to IRS when the preparer electronically files the tax return. If a tax return preparer required to complete the Form 8867 is not electronically filing the taxpayer's return with IRS, the regulations provides rules for submission of the form. If the tax return preparer required to complete the Form 8867 is not the signing tax return preparer, the preparer satisfies the submission requirement by providing a copy of the completed Form 8867 to the signing tax return preparer. If the tax return preparer required to complete the Form 8867 is the signing tax return preparer but the taxpayer is not electronically filing the return, the preparer must provide a copy of the completed Form 8867 to the taxpayer to be attached to the return being filed with IRS.

§6695(h), which was added by §208(c), Div. B of the Tax Increase Prevention Act of 2014 (the 2014 Act, P.L.113-295), provides that the penalty amount is indexed for inflation, effective for returns or claims for refund filed after December 31, 2014. As inflation-adjusted, the penalty was $505 for 2015, and is $510 for 2016 and 2017.

§6695(g) was amended by §207, Div. Q of the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act, P.L. 114-113) to expand the scope of the due diligence requirements to also include claims of the CTC/ACTC under §24 and the AOTC under §25A(a)(1), effective for tax years beginning after December 31, 2015.

The final Regulation §1.6695-2 regulations are amended to cross refer them to the temporary regulations, which reflect the changes made to §6695(g) by the PATH Act. The temporary regulations also conform the regulations to the 2014 Act, reflecting that the penalty is to be adjusted for inflation.

As a result of the PATH Act changes, one return or claim for refund may contain claims for more than one credit subject to the due diligence requirements. Each failure to comply with the due diligence requirements set out in regulations results in a penalty. The §6695(g) requirements apply to each credit claimed, meaning more than one penalty could apply to a single return or claim for refund. Examples in the temporary regulations show how multiple penalties could apply when one return or claim for refund is filed.

Form 8867, Paid Preparer's Due Diligence Checklist, has been revised for the 2016 tax year and is a single checklist to be used for all applicable credits (EIC, CTC/ACTC, and/or AOTC) on the return or claim for refund subject to the §6695(g) due diligence requirements. Form 8867 was streamlined to eliminate unnecessary redundancy with other forms and schedules. Regulation §1.6695-2T(b)(1)(ii) clarifies that the completion of Form 8867 can be based on information provided by the taxpayer to the preparer or otherwise reasonably obtained or previously known by the preparer.

Regulation §1.6695-2T(b)(3)(ii) provides updated examples to give more insight into when a tax return preparer has satisfied the due diligence knowledge requirement, including for purposes of the CTC and AOTC. The updates to the examples in Regulation §1.6695-2T(b)(3)(ii) illustrate that the knowledge requirement for purposes of due diligence can be satisfied in conjunction with a tax return preparer's information gathering activities done for the purpose of accurately completing other aspects of a tax return or claim for refund. New Example 2 and Example 4 have also been added to illustrate that in certain circumstances a tax return preparer may satisfy the knowledge requirement based on existing knowledge without having to make additional reasonable inquiries. New Example 7 provides an example of due diligence for purposes of the AOTC.

Regulation §1.6695-2T(a) reflects that IRS is required to index the penalty for inflation for returns or claims for refund filed after December 31, 2014.

Chief Counsel Advice 201733013.

Revenue Procedure 84-35, which provides criteria under which certain partnerships will not be subject to penalty under §6698 for failure to satisfy §6031(a) 's general filing requirement, does not provide an automatic exemption to those partnerships from the requirement of filing a Form 1065, U.S. Return of Partnership Income.

A partnership must file an information return, Form 1065, which reports items of gross income and allowable deductions. (§6031(a)) The return must also provide the names of all the partners and their distribute share of partnership income.

A partnership that fails to timely and completely file the return required by §6031(a) is subject to a penalty unless it is shown that the failure is due to reasonable cause. (§6698(a))

Legislative history underlying §6698 provides that:
The Committee understands that small partnerships (those with 10 or fewer partners) often do not file partnership returns, but rather each partner files a detailed statement of his share of partnership income and deductions with his own return... [T]he Committee believes that full reporting of the partnership income and deductions by each partner is adequate and that it is reasonable not to file a partnership return in this instance.

IRS then published Revenue Procedure 81-11, 1981-1 CB 651, in light of this Congressional intent. Revenue Procedure 81-11 provided a set of criteria under which partnerships with 10 or fewer partners will not be subject to the penalty under §6698, and was subsequently superseded by Revenue Procedure 84-35, which states that:
A domestic partnership composed of 10 or fewer partners and coming within the exception outlined in section 6231(a)(1)(B) of the Code will be considered to have met the reasonable cause test...provided that the partnership, or any of the partners, establishes, if so required by the Internal Revenue Service, that all partners have fully reported their shares of the income, deductions, and credits of the partnership on their timely filed income tax returns.

§6231(a)(1)(B) exempts small partnerships that meet certain requirements, including requirements pertaining to the identities of the partners, from the TEFRA audit procedures.

The issue raised in the CCA is whether Revenue Procedure 84-35 provides an automatic exemption to certain partnerships from the requirement to file a Form 1065.

The CCA concludes that, while Revenue Procedure 84-53 provides some relief from the penalty for failure to file a partnership return, it does not provide an automatic exemption from the filing requirement. Neither §6031 nor §6698 contain an exception to the general filing requirement in

§6031(a), and while Revenue Procedure 84-35 provides penalty relief in limited instances, such is not automatic.

The CCA reasoned that the individual partners' income tax returns, even if timely filed and complete, are not linked together during their initial processing, so IRS generally does not know how many partners are in the partnership or whether all of the partners timely filed their income tax returns unless and until the partnership (or one of its partners) is selected for an audit. Thus, the relief is not "automatic."

Further, the CCA noted that many partnerships-such as those having a trust as a partner-do not come within the "exception of section 6231(a)(1)(B)" and as such are not covered by Revenue Procedure 84-35. Additionally, Revenue Procedure 84-35 provides that IRS may presume that all partners have fully reported their shares of partnership income, etc. on their timely filed income tax return, but it may alternatively require the partners or partnership to establish that the partners have satisfied their filing requirements.

The CCA provides IRS's internal guidance for applying Revenue Procedure 84-35 (IRM 20.1.2.3.3.1), which states that the §6698 penalty may be avoided if the following requirements are met:

1. The partnership must consist of 10 or fewer partners. For the purpose of this requirement, a husband and wife (or their estate) filing a joint return is considered one partner.
2. Each partner is either an individual (excluding nonresident aliens) or the estate of a deceased partner.
3. Each partner's items of income, deductions, and credits are allocated in the same proportion as all other items of income, deductions, and credits.
4. The partnership has not elected to be subject to the consolidated audit procedures under §6221 through §6233.
5. Each partner reported his or her share of partnership income on his or her timely filed income tax return.

The IRM further instructs examiners that, when a partner requests abatement of the failure to file penalty because the partnership has ten partners or fewer, the partner (or representative) must confirm that:

1. All partners are qualifying partners,
2. All partners filed timely returns and included their share of partnership income on that return, and
3. The partnership is not subject to the consolidated (unified) audit procedures.

If an examiner finds that any partner filed late, or failed any other requirement, the examiner is instructed to not abate the penalty.

Chief Counsel Advice 201724025.

Where a taxpayer contracted with a professional employer organization (PEO) to, among things, remit the taxpayer's employment taxes, and the PEO failed to remit those taxes, taxpayer was liable for the taxes. The CCA rejected taxpayer's arguments that §3401(d)(1), which provides that a common law employer is not an employer for Federal income tax withholding purposes if he does not control the payment of wages, and Section 530 of the Revenue Act of 1978, provided him relief from that liability.

Under §3401(d)(1), if a common law employer does not have control of the payment of wages, the term "employer" means the person having control of the payment of wages. Although the Code imposes only Federal income tax withholding obligations on the §3401(d)(1) employer, case law has extended such an employer's obligations to include withholding and payment of FICA and FUTA taxes. See, e.g., *Otte,* (S Ct 1974) 34 AFTR 2d 74-6194. The key issue in determining whether a taxpayer is a §3401(d)(1) employer of employees leased to a client company is to establish whether the taxpayer was in control of the payment of wages to those employees.

Observation: The Tax Increase Prevention Act of 2014 (TIPA) enacted a rule that a "certified professional employer organization" (certified PEO), and no other person, is to be treated as the employer liable for employment taxes with respect to wages paid by the certified PEO to a work site employee performing services for any customer of the certified PEO. TIPA required IRS to establish a certification program by July 1, 2015, which was to have been effective for wages paid on or after January 1, 2016. IRS needed additional time to set it up and delayed the date that it would begin accepting applications for PEO certification until July 1, 2016.

The PEO in this CCA was not a certified PEO.

Section 530 of the Revenue Act of 1978 (Section 530), as amended, provides that a taxpayer that incorrectly treats an employee as an independent contractor is nevertheless exempt from employment tax liability if it meets three requirements:

a. the taxpayer does not treat any other individual holding a substantially similar position as an employee for purposes of employment taxes for any period;

b. The taxpayer has consistently treated the worker as not being an employee for post-1978 periods, including by filing all required federal tax returns on a basis consistent with this treatment; and

c. The taxpayer has a reasonable basis for not treating the individual as an employee.

If all three Section 530 requirements are met, then for purposes of applying employment taxes for a particular tax period with respect to a taxpayer, "the individual shall be deemed not to be an employee." If the worker is deemed not to be an employee, then the taxpayer has no employment tax liability with respect to remuneration paid to that worker for that period.

Taxpayer did not claim any deductions for officer compensation or salaries and wages on its tax return. Instead, Taxpayer claimed deductions for "Employee Leasing" for its entire workforce.

Prior to the years in issue, Taxpayer entered into a contract with a PEO. Under the contract: 1) Taxpayer assumes the responsibility for the day-to-day supervision and control of the individuals whom the PEO retains to work at Taxpayer's location, and the PEO does not have any liability, obligation or responsibility therefor; 2) Taxpayer must pay, at least one business day before each payroll date, an amount equal to all wages, salaries and any all other charges or payments to be paid to or with respect to the individuals who the PEO retains to work at Taxpayer's location; 3) Taxpayer must provide a security deposit or procure a letter of credit naming PEO beneficiary in the amount as determined by the PEO to cover wages, salaries, contributions, premiums and any and all other charges or payments to be paid to or with respect to the individuals who the PEO retains to work at Taxpayer's location; and 4) PEO may terminate the contract, immediately without notice, upon the occurrence of the Taxpayer's failure to pay any invoice in full in the amount and at the time specified when due or any breach or default of the contract by Taxpayer. The contract provides that, in the event of termination for any reason, Taxpayer is responsible for payment of all wages, salaries and employment related taxes.

The duties of the PEO under the contract include: 1) administering Taxpayer payroll, designated benefits, and personnel policies and procedures related to the individuals who the PEO retains to work at Taxpayer's location; and 2) remitting employment taxes and filing all employment tax returns with IRS and furnishing information returns to the individuals who the PEO retains to work at Taxpayer's location.

Taxpayer learned on audit that the PEO failed to remit applicable employment taxes to IRS and asserted that it paid the amount in question in full to the PEO and is not liable for the unpaid employment taxes that the PEO failed to remit to IRS.

IRS concluded that the PEO is not a "statutory employer" under §3401(d)(1) and that Taxpayer is not relieved of the employment taxes at issue.

IRS noted that several cases have dealt with the issue of what constitutes "control of the payment of wages" for purposes of determining if a taxpayer is a §3401(d)(1) employer.

In *Winstead* (CA 4 1997) 79 AFTR 2d 97-1977, the taxpayer owned land that was farmed by sharecroppers, who were accountable for their hired help. However, the sharecroppers could not pay the hired help until after the crops were sold. Therefore, the taxpayer paid the help from his checking account, over which the sharecroppers had no authority, then deducted what he paid from the sharecroppers' share of the crop proceeds. The taxpayer was held to have control of the payment of wages to the hired help and thus to be the employer under §3401(d)(1).

Conversely, in *In re Earthmovers Inc.,* (Bktcy Ct FL 1996) 78 AFTR 2d 96-6300, the taxpayer, Earthmovers, contracted with an employee leasing company, Sunshine. Pursuant to the terms of the contract, the employees were under the direction and control of Earthmovers, but Sunshine was responsible for the payment of wages to the employees, the collection of the appropriate payroll taxes from the paychecks, the payment of all employee withholding taxes due, and the filing of all necessary Federal tax forms. The court found that because Earthmovers submitted the information regarding the hours worked each week by each employee, forwarded the amount owed for payroll (including the tax amounts) to Sunshine, and retained the right to hire and fire the employees, Sunshine was not in control of the payment of wages for purposes of §3401(d)(1).

And, IRS noted other cases that have held a taxpayer to not be a §3401(d)(1) employer if the taxpayer received payroll information and funds from its client prior to the delivery of payroll to the client employees.

IRS concluded that, based on the provisions contained in the contract, the PEO is not considered to be in control of the payment of wages within the meaning of §3401(d)(1) because the PEO did not assume legal responsibility for payment of the wages to the employees. Under the terms of the contract, Taxpayer must pay the PEO an amount equal to the wages and salaries with respect to the workers in advance of the next payroll date. To ensure that the PEO will not be responsible for payment of wages to these workers, Taxpayer must provide a security deposit or letter of credit naming the PEO as beneficiary in the amount as determined by the PEO to cover the wages and salaries. Additionally, the PEO may terminate the contract immediately without notice, with Taxpayer being "responsible for payment of all wages, salaries and employment related taxes."

Thus, IRS said, the PEO acted merely as a conduit for Taxpayer in making payroll and does not meet the standards in §3401(d)(1).

IRS also concluded that Taxpayer is not entitled to relief under Section 530 because Section 530 is not applicable to the present dispute.

Section 530(a) focuses on the taxpayer's treatment of the worker as an employee and not the taxpayer's treatment of certain payments or services, the taxpayer's payment of its liability, or the determination of which party is liable for employment taxes on payments made to the taxpayer's employees. Congressional intent that Section 530 apply only to employee or nonemployee status determinations is reflected in the language found in Section 530(a)(1)(A) that the taxpayer "did not treat an individual as an employee for purposes of employment taxes."

Similarly, the legislative history of Section 530 shows that Congress was providing a relief provision limited to controversies regarding whether a worker was or was not an employee of a service recipient. It explains that, in the late 1960s, IRS increased its enforcement of the employment tax laws, causing significant controversies between taxpayers and IRS about whether individuals treated as independent contractors should be reclassified as employees. Until Congress had adequate time to study the matter, it provided relief for taxpayers who were involved in controversies with IRS "involving whether certain individuals are employees for purposes of the employment taxes." (Joint Committee on Taxation Staff, General Explanation of the Revenue Act of 1978, 95 Cong., at 301 (1979))

IRS said that, in the current fact pattern, there is no question regarding the proper classification status of the workers as Taxpayer's employees. In fact, the contractual arrangement between Taxpayer and the PEO is predicated upon the treatment of Taxpayer's workers as Taxpayer's employees for employment tax purposes. under the terms of the contractual agreement Taxpayer entered into with the PEO, Taxpayer was required to remit an amount equal to the wages paid to employees, along with the employer's share of FICA and the requisite amount of FUTA taxes prior to the end of the payroll period, so that the PEO could meet the payroll requirements and pay the workers while withholding the corresponding amount of employment taxes.

Although Taxpayer did not directly pay the wages to its employees, withhold taxes from the wages paid to its employees or file Federal employment and information returns, Taxpayer specifically contracted with a third party for purposes of fulfilling these obligations with respect to the treatment of the workers as its employees. Thus, the contractual arrangement, in and of itself, demonstrates that no underlying issue of employment tax classification status exists regarding those who received wage payments. Rather, the dispute is limited to whether Taxpayer, as the common law employer, remains ultimately liable for the unpaid employment taxes at issue. As such, Section 530 is not applicable.

Chief Counsel Advice 201719026.

Notwithstanding the fact that the offshore voluntary compliance program (OVDP)-the program for taxpayers that have failed to meet foreign bank account reporting requirements-requires the filing of amended returns for eight tax years, IRS can refund an overpayment on such a return only if the taxpayer has complied with the normal timely refund claim requirements of §6511.

Taxpayers with foreign bank accounts are required to make various disclosures. The OVDP is a program that was made available beginning in 2009 to certain taxpayers with previously undisclosed foreign bank accounts. The current OVDP rules apply to OVDP submissions made after July 1, 2014.

As a condition of entering the program, taxpayers must disclose the existence of their previously undisclosed foreign accounts. They are required to file either original or amended tax returns which include the income earned by their foreign accounts for the most recent eight tax years for which the due date has passed (disclosure period). Taxpayers are also required to submit properly executed agreements to extend the period of limitations on assessment under §6501 for each of the eight tax years included in the disclosure period. In addition, taxpayers agree to be responsible for the tax due, interest, and penalties, including the accuracy-related penalty and the failure to file and failure to pay penalties of §6651(a)(1) and §6651(a)(2). In return, they are absolved of other penalties, e.g., the fraud penalty. (2014 OVDP Frequently Asked Questions)

§6514(a)(1) prohibits IRS from crediting or refunding any overpayment unless the taxpayer timely filed a claim for refund or credit of such amount. §6511(a) requires that a claim for refund or credit be filed within three years from the time the original return was filed or two years from the time the tax was paid, whichever is later. In addition, the amount of any refund or credit is limited by §6511(b), which provides either: (1) a 3-year look-back period in cases in which the claim was filed within three years of the return or (2) a 2-year look-back period in cases in which the claim was filed within two years of payment.

§6511(c) provides a special rule for situations where a taxpayer has executed a consent to extend the statute of limitations on assessment pursuant to §6501(c)(4). §6511(c)(1) provides that, when a taxpayer enters into an agreement to extend the period of limitations on assessment during the 3-year refund or credit period prescribed in §6511(a), the period for filing a timely claim for refund or credit does not expire prior to six months after the expiration of the assessment period as extended by that agreement. Where a claim for refund or credit is filed within the period prescribed by §6511(c)(1), §6511(c)(2) limits the amount of the refund or credit to the portion of the tax paid after the execution of statute extension plus the portion of the tax paid within the look-back period which would be applicable under §6511(b)(2) if the claim for refund or credit had been filed on the date that the statute extension was executed.

In addition to the special rule in §6511(c), §6511(d) also lists a variety of other special circumstances under which the period for filing a claim for refund or credit may be extended. For example, §6511(d)(2) provides for an extended period where the claim for refund or credit relates to a net operating loss carryback, and §6511(d)(3) provides for an extended period where the claim relates to a foreign tax credit.

The taxpayer is an OVDP participant for whom the disclosure period is tax years 2003 through 2010. For tax years 2003 through 2007 and 2009 and 2010, the taxpayer reports additional income and tax on his OVDP amended returns. But the amended return submitted for tax year 2008 includes a large loss, resulting in an overpayment for that tax year. After reviewing the amended return, the examining agent confirms the claimed loss, and the resulting tax computations show an overpayment for tax year 2008. The taxpayer then requests that the overpayment for tax year 2008 be credited against increases in tax for the other tax years in the disclosure period.

How do §6511 and §6514 affect IRS's ability to credit the overpayment as requested by the taxpayer?

The CCA concluded that, if the taxpayer's claim was filed within the period prescribed by §6511, the claim is timely, and the taxpayer is entitled to a credit for the overpayment of amounts paid within the relevant look-back period. If the claim for refund was not filed within the period prescribed by §6511, the overpayment is barred and §6514 prohibits IRS from crediting it against liabilities for other tax types or periods.

The CCA then noted that it did not have all of the relevant facts and considered some hypothetical fact situations.

If, for example, the taxpayer entered the OVDP in March, 2012, there is a good chance that the taxpayer's 2008 amended return was filed within the 3-year period described in §6511(a). If, on the other hand, the taxpayer entered the OVDP in March, 2014, it is less likely that the amended return was filed within the 3-year period described in §6511(a). It is certainly possible that the amended return was filed within that 3-year period, particularly if the original 2008 return was filed late, although there may not be any payments in the 3-year look back period prescribed by §6511(b)(2)(A).

It is also possible that the taxpayer made payments with respect to the 2008 tax year after the 2008 return was filed. If the amended return was filed within two years of any payment, it would also be timely filed. However, §6511(b)(2)(B) would limit the amount of the refund or credit to amounts paid within the 2-year period preceding the filing of the claim.

A claim for refund or credit for 2008 might also be timely by virtue of §6511(c)(1). If a taxpayer and IRS entered into an agreement under §6501(c)(4) extending the taxpayer's 2008 period of limitations on assessment during the 3-year period described in §6511(a), then the taxpayer's claim for refund or credit would be timely as long as it was filed within six months of the expiration of the of the period within which assessment may be made pursuant to the agreement or any extension thereof.

However, as with claims filed within the standard 3- or 2-year periods described in §6511(a), claims considered timely under §6511(c)(1) are also subject to amount limitations. Therefore, even if the hypothetical taxpayer executed a statute extension within the period provided for by §6511(a), §6511(c)(2) would limit the amount of the 2008 overpayment available for credit, to the portion of the tax paid after the execution of statute extension, plus the portion of the tax paid within the look-back period which would be applicable under §6511(b)(2) if the claim for refund or credit had been filed on the date that the statute extension was executed. If the statute extension was executed within three years of the original return, the look-back period would be three years. If the statute was executed within two years of a payment, the look-back period would be two years.

In determining whether a taxpayer's claim for refund or credit is timely filed, IRS agents should also consider whether the taxpayer's claim falls within any of the special circumstances described in any subsection of §6511(d).

Chief Counsel Advice 201650019.

An electronic signature should only be accepted by IRS when there is published guidance or Internal Revenue Manual (IRM) provisions that specifically authorize use of an electronic signature for the specific form involved.

§6061(a) provides the general rule that any return, statement, or other document required to be made under any provision of the internal revenue laws or regulations must be signed in accordance with forms or regulations prescribed by IRS. Although the Code does not define the term "signature," 1 USC 1 provides that a "signature" includes a mark when the person declaring the same intended it as such, and §6061(b)(1) provides that IRS must establish procedures for accepting signatures in digital or other electronic form. The Code does not provide detailed rules for the use of electronic signatures beyond authorizing their use in §6061.

The use of electronic signatures in transactions involving almost all federal organizations other than IRS is primarily governed by the Government Paperwork Elimination Act, Pub. L. No. 105-277, Div. C, Title XVII (codified at 44 USC 3504) (GPEA). GPEA by its terms does not apply to IRS. (GPEA §1709)

IRS auditors asked Chief Counsel whether IRS may accept a Form 2678, Employer/Payer Appointment of Agent that displays an electronic signature. The employer will fill out the Form 2678 online and sign it with a mouse or stylus. The signature will be created by the person with a live signature, but IRS will receive a digital image of the actual signature. The Form will be mailed to IRS, and a vendor will maintain a digital image of the completed form.

Chief Counsel says not to accept the signature. Chief Counsel says that an electronic signature should only be accepted by IRS when there is published guidance or IRM provisions that specifically authorize use of an electronic signature for the specific form involved. Since there is no guidance or IRM provisions authorizing the use of an electronic signature on Forms 2678, Chief Counsel recommended that IRS not accept Forms 2678 signed electronically until IRS authorizes that use for Forms 2678 either in published guidance or in the IRM.

Chief Counsel said that, although GPEA by its terms does not apply to IRS, its provisions are useful in analyzing the legal and policy underpinnings of the use of electronic signatures by governmental agencies. GPEA defines the term "electronic signature" as "a method of signing an electronic message that -- (A) identifies and authenticates a particular person as the source of the electronic message; and (B) indicates such person's approval of the information contained in the electronic message." (GPEA §1710) It is a generic, technology-neutral term that refers to the universe of all of the various methods by which one can sign an electronic record. An electronic signature is legally equivalent to a handwritten signature and may not be denied legal effect, validity, or enforceability solely because it is in electronic form. (GPEA §1707)

However, Chief Counsel said, all signatures, whether paper or electronic, are subject to challenge for other reasons, such as claims of forgery, lack of authority, mistake, or duress. Accordingly, although electronic signatures are legally valid, the utility of using electronic signatures must be balanced against the risk of disavowal by the signer. In the case of signatures signed by IRS employees, the risk of disavowal is extremely low. Taxpayers or agents, by contrast, may challenge an electronic signature, especially in the case of documents that may fix the taxpayers' or agents' liability and may be introduced in court proceedings. In those cases dealing with high-risk documents, taxpayers should either be required to sign by non-electronic means or IRS should institute heightened authentication, security procedures, and electronic signing processes to protect IRS against the risk of disavowal by the taxpayer.

Consequently, Chief Counsel said, if IRS should make the business decision to accept electronic signatures on Forms 2678, it recommends that IRS adopt procedures that not only are consistent with GPEA but also incorporate security procedures to protect IRS from taxpayer challenges either that the taxpayer did not sign the form or that the electronic signature process is invalid. Accordingly, for purposes of creating a valid and enforceable electronic signature, IRS should adopt electronic signing procedures that satisfy the following signing requirements:

1. A person (i.e., the signer) must use an acceptable electronic form of signature;

2. The electronic form of signature must be executed or adopted by a person with the intent to sign the electronic record, (e.g., to indicate a person's approval of the information contained in the electronic record);

3. The electronic form of signature must be attached to or associated with the electronic record being signed;

4. There must be a means to identify and authenticate a particular person as the signer; and

5. There must be a means to preserve the integrity of the signed record.

These guidelines are consistent with those issued by the Office of Management and Budget in 2013.

Finally, Chief Counsel said, should IRS choose to authorize the use of electronic signatures on Form 2678, the appropriate IRM provision and Form instructions should be revised to set forth the procedures under which that form can be electronically signed.

Chief Counsel Advice 201644020.

Suspension of the limitations periods on assessment and collection under §6503(a) applies where a proceeding in respect of a deficiency is docketed in the Tax Court, even if IRS had not mailed a deficiency notice. The CCA further clarified that any contrary IRM guidance is incorrect.

When IRS determines a deficiency, it issues a statutory notice of deficiency to inform the taxpayer of the basis for the deficiency, the amounts (if any) of tax, interest, additional amounts, additions to tax and assessable penalties, and the date by which the taxpayer may file a petition in the Tax Court contesting the deficiency. (§6212(a))

In general, there is a 3-year statute of limitations on assessment under §6501(a) and a 10-year limitations period on collection under §6502(a).

Under §6503(a), the running of the limitations periods on assessment or collection under §6501 or §6502 is suspended during the period in which IRS is prohibited from making an assessment, and during the pendency of a Tax Court case "in respect of" the deficiency plus an additional 60 days.

§6503(a) states:

The running of the period of limitations provided in section 6501 or 6502...shall (after the mailing of a notice under section 6212(a)) be suspended for the period during which the Secretary is prohibited from making the assessment or from collecting by levy or a proceeding in court (and in any event, if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, until the decision of the Tax Court becomes final), and for 60 days thereafter.

Internal Revenue Manual (IRM) Section 8.20.7.21.2 states if a petition docketed in the Tax Court is dismissed for lack of jurisdiction because IRS did not issue a deficiency notice, the period of limitation on assessment is not suspended.

The CCA addressed whether the suspension of the limitations period on assessment under §6503(a) applies when a proceeding in respect of a deficiency is docketed in the Tax Court, but IRS did not issue a deficiency notice regarding the deficiency to the taxpayer.

The CCA concluded that the suspension on the period of limitations on assessment is suspended if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, until 60 days after the decision of the Tax Court becomes final, and this suspension applies regardless of whether a deficiency notice was issued to the taxpayer for that deficiency or not.

IRS reasoned that the "in any event" language in the second parenthetical of §6503(a), above, extends the suspension to cases where IRS was not prohibited from making the assessment or collection, as well as to cases where IRS did not mail a deficiency notice to the taxpayer regarding that deficiency.

Accordingly, the suspension of the periods of limitation on assessment applies where a proceeding in respect of a deficiency is docketed in the Tax Court, even if IRS did not mail a deficiency notice, and any contrary indication in the IRM is incorrect.

Chief Counsel Notice 2017-007.

IRS has instructed IRS Counsel Attorneys as to how they should communicate and otherwise interact with unenrolled return preparers who are given power of attorney by a taxpayer who is a litigant in a case being worked on by the Counsel attorney.

Revenue Procedure 2014-42, 2014-29 IRB 192, allows an unenrolled return preparer to represent a taxpayer before IRS during examination if the unenrolled return preparer: (i) has a valid Annual Filing Season Program Record of Completion for the calendar year in which the tax return or claim for refund was signed and filed, and (ii) has a valid Annual Filing Season Program Record of Completion for the year or years in which the representation occurs. The representation authorized by Revenue Procedure 2014-42 does not permit an unenrolled return preparer to represent a taxpayer before appeals officers, revenue officers, or the Office of Chief Counsel. Revenue Procedure 2014-42 is effective with respect to returns or claims for refund prepared and signed after December 31, 2015. With respect to returns prepared and signed before December 31, 2015, limited practice rights of unenrolled return preparers are governed by Revenue Procedure 81-38, 1981-2 CB 592, which also prohibits unenrolled return preparers from representing taxpayers before Chief Counsel or Appeals.

Form 2848, Power of Attorney and Declaration of Representative, is used by taxpayers to designate persons to represent them in various ways in dealing with IRS. Part II, Box h on that form is used to so designate an unenrolled return preparer.

Informal conferences between IRS Counsel and a taxpayer for discovery purposes are typically called "Branerton conferences." (*Branerton Corporation ,* (1974) 61 TC 691)

Noting that questions have been posed to Chief Counsel about Counsel's interaction in situations in which the representative authorized by the taxpayer's Form 2848 selects designation "h," the CCN sets out a series of instructions as to how Counsel attorneys should interact with those unenrolled return preparers.

Under both Revenue Procedure 2014-42 and Revenue Procedure 81-38, unenrolled return preparers are not permitted to represent a taxpayer before Counsel. Therefore, an unenrolled return preparer is not an authorized representative, even if the unenrolled return preparer has obtained the necessary Annual Filing Season Program Records of Completion. Therefore, the unenrolled return preparer may not act as taxpayer's representative before Counsel. For example, unenrolled return preparers may not represent a taxpayer at a Branerton conference or other meeting with Counsel or sign any documents on a taxpayer's behalf.

However, if the involvement of an unenrolled return preparer is beneficial to the resolution of the case, Counsel Attorneys may work with the unenrolled return preparer, in a non-representative capacity, to develop the facts of a case. For example, the unenrolled return preparer might provide records substantiating items reported on a return or otherwise provide information about the facts underlying a particular reporting position. In addition, Counsel Attorneys may allow the unenrolled return preparer to attend a meeting along with the taxpayer. To avoid confusion, Counsel Attorneys should clarify with both the taxpayer and the unenrolled return preparer that unenrolled return preparers do not have the authority to represent taxpayers in dealings with Chief Counsel, even if the taxpayer purports to consent to the representation.

Counsel attorneys should interact with an unenrolled return preparer in the same manner and to the same extent that they would interact with any other non-representative that a taxpayer might bring to a meeting about the taxpayer's Tax Court case. Counsel attorneys are not required to communicate with an unenrolled return preparer or include the unenrolled return preparer in meetings if, for example, the unenrolled return preparer is abusive or disruptive or if the interests of the return preparer conflict with the interests of the taxpayer. Further, because an unenrolled preparer is not the taxpayer's representative, Counsel Attorneys should not send copies of pleadings or other documents to the unenrolled return preparer. Counsel attorneys may only communicate with the unenrolled return preparer while the taxpayer is present, either in person or on the telephone, or in the unenrolled return preparer's capacity as a third party record keeper or a potential witness.

Chief Counsel Notice 2017-006.

IRS has instructed IRS Counsel Attorneys regarding how they should interact with taxpayers and taxpayer representatives in situations in which the taxpayer representative is providing only limited scope legal services to the taxpayer.

The Tax Court Rules of Practice and Procedure require that all practitioners before the court, including Chief Counsel Attorneys, carry on their practice in accordance with the letter and the spirit of the American Bar Association (ABA) Model Rules of Professional Conduct. (TC Rule 201(a))

ABA Model Rule 4.2 provides that, "in representing a client, a lawyer shall not communicate about the subject of the representation with a person the lawyer knows to be represented in the matter, unless the lawyer has the consent of the other lawyer or is authorized to do so by law or a court order." The prohibition "only applies in circumstances where the lawyer knows that the person is represented in the matter to be discussed." (ABA Model Rules of Professional Conduct 4.2 comment 8)

On November 30, 2015, the ABA Committee on Ethics and Professional Responsibility issued Formal Opinion 472, which provides guidance about communicating with persons who are receiving limited scope legal services.

ABA Formal Opinion 472 provides guidance on the application of Rule 4.2 in situations where a person is represented by an attorney in some, but not all, aspects of a matter. The opinion concludes that an attorney must comply with Rule 4.2 and communicate with a person's attorney when the communication concerns "an issue, decision, or action" for which that person is represented. If the scope of the limited representation is not clear, an attorney should contact the limited-scope representative to identify the issues or aspects of the matter with respect to which the person is represented.

Formal Opinion 472 provides that when an attorney has reason to know that a person may be represented with respect to some portion of a matter, he or she should inquire about whether the person is receiving limited scope legal services. ABA Model Rule 4.2's prohibition on communicating with a represented person applies where an attorney knows that the person is represented in the matter. However, as discussed in both Formal Opinion 472 and Comment 8 to Rule 4.2, knowledge that a person is represented can be inferred from circumstances, and an attorney cannot evade the requirements of Rule 4.2 by "closing eyes to the obvious." If circumstances-for example, a pleading filed by a pro se litigant that appears to have been prepared by an attorney-indicate that a person is receiving limited scope legal services, the opinion recommends asking whether the person is represented by counsel with respect to any portion of the matter.

Tax Court Rule 24(b) defines when a person is represented in a matter in litigation before the Tax Court, stating that "in the absence of an appearance by counsel, a party will be deemed to appear on the party's own behalf." A taxpayer is, therefore, only considered by the Tax Court to be represented by counsel in a docketed case if that taxpayer's representative has entered a formal appearance. Thus, a representative who has not entered an appearance does not have the authority, for example, to bind the taxpayer to a stipulation of facts or stipulated decision, or to communicate with the court on the taxpayer's behalf.

IRS has now provided guidance to Chief Counsel Attorneys on how to deal with both a taxpayer and his or her representative in situations in which the taxpayer representative is providing only limited scope legal services to the taxpayer.

In light of Formal Opinion 472, Chief Counsel Attorneys should communicate with a representative providing limited scope legal services when the communication concerns an issue, decision, or action that is within the scope of the limited representation. This advice applies even where the representative has not entered an appearance in the Tax Court. Where circumstances indicate that a pro se taxpayer may be receiving assistance from an attorney who has not entered an appearance, Chief Counsel Attorneys should ask the taxpayer if he or she is represented in some or all aspects of the Tax Court case. If the taxpayer states that he or she has limited representation, but the scope of the limited representation cannot be determined from the information provided by the taxpayer, the Counsel attorney should contact the limited scope representative for clarification.

The CCN instructs Counsel Attorneys to seek advice within the Chief Counsel's office if they have questions about circumstances in which a taxpayer may be receiving limited scope legal services. For example, they are instructed to seek advice if they are unsure whether a pleading filed in a case indicates that a taxpayer is receiving limited scope legal services or if a taxpayer does not respond to inquiries about whether he or she is receiving limited scope legal services.

The CCN also reminds Counsel Attorneys that, before communicating with a taxpayer's representative who has not entered an appearance, they must obtain from either the taxpayer or the representative a valid Form 2848 (Power of Attorney and Declaration of Representative) or other valid disclosure authorization covering the tax years and tax types at issue in the docketed case. In addition, in order to provide effective service, pleadings and other documents must be served on the pro se taxpayer, in addition to any copies that are provided to the limited scope representative.

Section 530 of the Revenue Act of 1978 (Section 530), as amended, provides that a taxpayer that incorrectly treats an employee as an independent contractor is nevertheless exempt from employment tax liability if it meets three requirements:

a. The taxpayer does not treat any other individual holding a substantially similar position as an employee for purposes of employment taxes for any period;

b. The taxpayer has consistently treated the worker as not being an employee for post-1978 periods, including by filing all required federal tax returns on a basis consistent with this treatment; and

c. The taxpayer has a reasonable basis for not treating the individual as an employee.

If all three Section 530 requirements are met, then for purposes of applying employment taxes for a particular tax period with respect to a taxpayer, "the individual shall be deemed not to be an employee." If the worker is deemed not to be an employee, then the taxpayer has no employment tax liability with respect to remuneration paid to that worker for that period.

Taxpayer did not claim any deductions for officer compensation or salaries and wages on its tax return. Instead, Taxpayer claimed deductions for "Employee Leasing" for its entire workforce.

Prior to the years in issue, Taxpayer entered into a contract with a PEO. Under the contract: 1) Taxpayer assumes the responsibility for the day-to-day supervision and control of the individuals whom the PEO retains to work at Taxpayer's location, and the PEO does not have any liability, obligation or responsibility therefor; 2) Taxpayer must pay, at least one business day before each payroll date, an amount equal to all wages, salaries and any all other charges or payments to be paid to or with respect to the individuals who the PEO retains to work at Taxpayer's location; 3) Taxpayer must provide a security deposit or procure a letter of credit naming PEO beneficiary in the amount as determined by the PEO to cover wages, salaries, contributions, premiums and any and all other charges or payments to be paid to or with respect to the individuals who the PEO retains to work at Taxpayer's location; and 4) PEO may terminate the contract, immediately without notice, upon the occurrence of the Taxpayer's failure to pay any invoice in full in the amount and at the time specified when due or any breach or default of the contract by Taxpayer. The contract provides that, in the event of termination for any reason, Taxpayer is responsible for payment of all wages, salaries and employment related taxes.

The duties of the PEO under the contract include: 1) administering Taxpayer payroll, designated benefits, and personnel policies and procedures related to the individuals who the PEO retains to work at Taxpayer's location; and 2) remitting employment taxes and filing all employment tax returns with IRS and furnishing information returns to the individuals who the PEO retains to work at Taxpayer's location.

Taxpayer learned on audit that the PEO failed to remit applicable employment taxes to IRS and asserted that it paid the amount in question in full to the PEO and is not liable for the unpaid employment taxes that the PEO failed to remit to IRS.

IRS concluded that the PEO is not a "statutory employer" under §3401(d)(1) and that Taxpayer is not relieved of the employment taxes at issue.

IRS noted that several cases have dealt with the issue of what constitutes "control of the payment of wages" for purposes of determining if a taxpayer is a §3401(d)(1) employer.

In *Winstead* (CA 4 1997) 79 AFTR 2d 97-1977, the taxpayer owned land that was farmed by sharecroppers, who were accountable for their hired help. However, the sharecroppers could not pay the hired help until after the crops were sold. Therefore, the taxpayer paid the help from his checking account, over which the sharecroppers had no authority, then deducted what he paid from the sharecroppers' share of the crop proceeds. The taxpayer was held to have control of the payment of wages to the hired help and thus to be the employer under §3401(d)(1).

Conversely, in *In re Earthmovers Inc.,* (Bktcy Ct FL 1996) 78 AFTR 2d 96-6300, the taxpayer, Earthmovers, contracted with an employee leasing company, Sunshine. Pursuant to the terms of the contract, the employees were under the direction and control of Earthmovers, but Sunshine was responsible for the payment of wages to the employees, the collection of the appropriate payroll taxes from the paychecks, the payment of all employee withholding taxes due, and the filing of all necessary Federal tax forms. The court found that because Earthmovers submitted the information regarding the hours worked each week by each employee, forwarded the amount owed for payroll (including the tax amounts) to Sunshine, and retained the right to hire and fire the employees, Sunshine was not in control of the payment of wages for purposes of §3401(d)(1).

And, IRS noted other cases that have held a taxpayer to not be a §3401(d)(1) employer if the taxpayer received payroll information and funds from its client prior to the delivery of payroll to the client employees.

IRS concluded that, based on the provisions contained in the contract, the PEO is not considered to be in control of the payment of wages within the meaning of §3401(d)(1) because the PEO did not assume legal responsibility for payment of the wages to the employees. Under the terms of the contract, Taxpayer must pay the PEO an amount equal to the wages and salaries with respect to the workers in advance of the next payroll date. To ensure that the PEO will not be responsible for payment of wages to these workers, Taxpayer must provide a security deposit or letter of credit naming the PEO as beneficiary in the amount as determined by the PEO to cover the wages and salaries. Additionally, the PEO may terminate the contract immediately without notice, with Taxpayer being "responsible for payment of all wages, salaries and employment related taxes."

Thus, IRS said, the PEO acted merely as a conduit for Taxpayer in making payroll and does not meet the standards in §3401(d)(1).

IRS also concluded that Taxpayer is not entitled to relief under Section 530 because Section 530 is not applicable to the present dispute.

Section 530(a) focuses on the taxpayer's treatment of the worker as an employee and not the taxpayer's treatment of certain payments or services, the taxpayer's payment of its liability, or the determination of which party is liable for employment taxes on payments made to the taxpayer's employees. Congressional intent that Section 530 apply only to employee or nonemployee status determinations is reflected in the language found in Section 530(a)(1)(A) that the taxpayer "did not treat an individual as an employee for purposes of employment taxes."

Similarly, the legislative history of Section 530 shows that Congress was providing a relief provision limited to controversies regarding whether a worker was or was not an employee of a service recipient. It explains that, in the late 1960s, IRS increased its enforcement of the employment tax laws, causing significant controversies between taxpayers and IRS about whether individuals treated as independent contractors should be reclassified as employees. Until Congress had adequate time to study the matter, it provided relief for taxpayers who were involved in controversies with IRS "involving whether certain individuals are employees for purposes of the employment taxes." (Joint Committee on Taxation Staff, General Explanation of the Revenue Act of 1978, 95 Cong., at 301 (1979))

IRS said that, in the current fact pattern, there is no question regarding the proper classification status of the workers as Taxpayer's employees. In fact, the contractual arrangement between Taxpayer and the PEO is predicated upon the treatment of Taxpayer's workers as Taxpayer's employees for employment tax purposes. under the terms of the contractual agreement Taxpayer entered into with the PEO, Taxpayer was required to remit an amount equal to the wages paid to employees, along with the employer's share of FICA and the requisite amount of FUTA taxes prior to the end of the payroll period, so that the PEO could meet the payroll requirements and pay the workers while withholding the corresponding amount of employment taxes.

Although Taxpayer did not directly pay the wages to its employees, withhold taxes from the wages paid to its employees or file Federal employment and information returns, Taxpayer specifically contracted with a third party for purposes of fulfilling these obligations with respect to the treatment of the workers as its employees. Thus, the contractual arrangement, in and of itself, demonstrates that no underlying issue of employment tax classification status exists regarding those who received wage payments. Rather, the dispute is limited to whether Taxpayer, as the common law employer, remains ultimately liable for the unpaid employment taxes at issue. As such, Section 530 is not applicable.

Legal Advice Issued by Associate Chief Counsel 2017-004

IRS has addressed a number of issues involving disclosure of returns, return information, etc. where the return was filed by an identity thief or by an undocumented worker with a stolen Social Security number (SSN).

§6103(a) provides the general rule that returns and return information must be kept confidential and can only be disclosed as authorized under the Code.

The term "return" means any tax or information return, declaration of estimated tax, or claim for refund required by, or provided for or permitted under, the Code, and filed with IRS by, or on behalf of, any person. (§6103(b)(1))

Return information includes the taxpayer's identity and any taxpayer-related information that is "received by, recorded by, prepared by, furnished to, or collected by IRS." But return information does not include data in a form that cannot be associated with, or otherwise identify, directly or indirectly a particular taxpayer. (§6103(b)(2))

An individual has a right to view his or her own return under §6103(e)(1)(A)(i).

IRS must withhold return information if disclosing such information would "seriously impair Federal tax administration." (§6103(e)(7))

Refund fraud typically involves a perpetrator who has stolen an identity and files a tax "return" early in the filing season using a Form 1040, U.S. Individual Income Tax Return, in the name or with the taxpayer identification number (TIN), e.g., Social Security Number (SSN) or Employer Identification Number (EIN), of the victim, who has not yet filed a return for the tax year. The perpetrator will often attach to the Form 1040 one or more false Forms W-2 showing bogus wages and withholding credits, thereby providing the basis for the purported refund. When the identity theft victim later files a legitimate return for the tax year, IRS will likely flag it because of the significant discrepancies with the prior filed return and, pending resolution, freeze any refund claimed on the second return. Eventually, through investigation, the identity theft and the fraud will become apparent.

A variation of this scenario involves filing return forms in the name of a business to claim a fraudulent refund. In other situations, an identity thief uses another taxpayer's information to claim that taxpayer as a dependent in order to create additional deductions.

In another common scenario, an undocumented worker, who does not have the legal status to work in the U.S., uses the victim's stolen SSN to appear work-eligible. The undocumented worker provides the SSN to the worker's employer, and the employer in turn files a Form W-2 reporting the worker's wages and tax withholding under the SSN provided. The undocumented worker then files a return, along with Form W-2, that reflect the identity theft victim's SSN and name along with the actual wages and tax withheld of the undocumented worker. In processing the return, IRS may attribute the wages to the identity theft victim and determine additional tax due.

Another variation on this scenario would involve the undocumented worker utilizing the victim's SSN on the Form W-2, but would vary in that the return would contain the Individual Taxpayer Identification Number (ITIN), along with the actual wages and tax withheld, of the undocumented worker, and the only information of the victim would be the SSN on the Form W-2 submitted with the return. In this variation, there are no tax consequences to the victim as the wages are not attributed to the victim, but, nonetheless, the victim's account is marked with an indicator of employment-related identity theft.

IRS said that when it confronts identity theft and refund fraud, complex disclosure questions often arise. The determination of whether to release certain information depends on numerous factors, including what kind of return information is involved, whose return information it is, and who would receive the information in a disclosure.

Some identity theft "returns" are not returns for §6103 purposes. If a return form is not a valid return, the document itself does not qualify for disclosure protections under §6103. An invalid return is not "required by, or provided for or permitted under" the Code, as described in §6103(b)(1), so if a document is not a valid return, it may not be afforded disclosure protection under §6103.

Requirements for a valid return include that the return be filed as part of an honest and reasonable attempt to comply with the tax laws and that the return be signed by the purported taxpayer under the penalties of perjury. See *Beard, (1984) 82 TC 766.* A return form that is filed by an identity thief using a victim's name and TIN and that attempts to intercept the victim's refund is generally not a valid return and therefore is not afforded protection under §6103(b)(1).

The method through which the identity thief obtains stolen information likely will not make a difference in whether the document is a valid return. For example, if an identity thief steals the EIN of a company to file a fraudulent return and take the company's refund, the return is invalid. If, instead, the identity thief steals an SSN and then applies for an EIN under that stolen name, the return form filed using that fake EIN is still invalid because it was not filed as part of an honest and reasonable attempt to comply with the tax laws and is not signed by the person in whose name the purported return is filed.

Note that this rule does not apply in the case of an undocumented worker who uses a stolen SSN, but otherwise reports actual wages. His W-2 would be a valid return because, under the circumstances, it represents a reasonable effort to comply with the tax laws. The employer is filing the W-2 in order to comply with employment tax responsibilities, and although there are penalties for filing information returns with missing or incorrect information under §6721, this Form W-2 is not a sham return like a fictitious refund return. The form reflects a real employment relationship with associated wage payments and tax withholding and is filed as a good-faith information return.

Identity theft "returns" are "return information" protected under §6103. Although the return of an identity thief seeking a fraudulent refund is a nullity, the return may be legally protected "return information" under the broad definition of return information in §6103(b)(2)(A). The document is return information because it is "received by, recorded by, prepared by, furnished to, or collected by" IRS as part of a determination of liability, or potential liability under the Code. (§6103(b)(2)(A)) Assuming there is some potential liability to be determined under the Code, the document does qualify as return information, and it can only be disclosed as authorized by the Code. (§6103(a))
A fraudulent refund return is the return information of both the victim and the thief from the moment it is filed with IRS. When a fraudulent refund return is first filed with IRS, IRS will assume it is the return information of the victim, since the victim's identifying information is on the return.

Information such as the date the return was filed, the document locator number assigned to it, the liability and payment amounts reported on the return, and the steps taken to process the return will all be posted to the victim's account for that tax year. All this information was collected by IRS with respect to the possible tax liability of the victim, making that information the victim's return information.

At the same time, the identity thief, by knowingly filing a false return, subjects himself to other possible liabilities, so the return is the thief's return information as well. As a result, the return filed in an identity theft scenario is often the return information of both the victim and the thief. Even though IRS may not be aware that the return or return information belongs to the thief until the identity theft is discovered, it is still the return information of the identity thief from the moment it is filed with IRS.

If a victim is listed as a dependent on a fraudulent return, the return is not the return information of the victim.

For returns filed by an employer, the return information is generally the employer's, the employee's, and the victim's. The type of return may also be relevant to determining the "owner" of the return information. For example, when an employer files a Form W-2 with IRS, the information contained in that return is return information both of the employer and the employee. As a result, in the case of an undocumented worker using someone else's SSN, the return information belongs to the employee/undocumented worker, to the employer, and to the victim.

A return filed using a fraudulent EIN, which was obtained using a stolen SSN, is not the return information of the victim.

IRS may disclose a taxpayer's return information to the taxpayer, but an identity thief is not necessarily a taxpayer. §6103(e)(1)(A)(i) and §6103(e)(7) authorize IRS to release returns and return information of any taxpayer to the taxpayer himself. As a result, if information related to an identity theft return is the victim's return information, IRS may disclose that information to the victim. Additionally, an undocumented worker's return or return information may be disclosed to the worker.

There is an argument, however, that a refund fraud identity thief must demonstrate that he is a taxpayer before IRS can disclose return information to him as the taxpayer under §6103(e)(7). §7701(a)(14) defines the term "taxpayer" as "any person subject to any internal revenue tax." An identity thief generally has not filed the fraudulent return because he is subject to some internal revenue tax. Unless the identity thief can demonstrate that he is subject to an internal revenue tax, the identity thief is not entitled to his return information.

A taxpayer may consent to the disclosure of his or her own return information.

IRS is not authorized to disclose the identity thief's separate and distinct return information to an identity theft victim. The Code provides no authority for disclosure of an identity thief's separate and distinct return information to an identity theft victim. The victim is not even entitled to disclosure of the identity thief's identity. However, where the information is the return information of both the victim and the thief, IRS may legally disclose the information to the victim. IRS, however, may conclude as a matter of policy that disclosure of return information of the thief to the victim will impair tax administration and accordingly refuse to make such disclosures. See §6103(e)(7).

IRS does allow victims to obtain redacted versions of identity thieves' returns.

IRS is authorized to disclose return information to other employees of the Department of the Treasury.

IRS is authorized to disclose return information in a Federal or State judicial or administrative tax proceeding.

Legal guardians of minor victims may obtain copies of the minor victim's return information.

In some circumstances, IRS may disclose return information, but not "taxpayer return information," to other Federal agencies.

IRS may only disclose return information to state and local officials if they are considered Federal employees for §6103 purposes.

IRS may disclose information to confirm a return's legitimacy.

Information from an identity theft return should not be disclosed if that information would seriously impair Federal tax administration.

Victims may obtain copies of fraudulent returns. IRS has determined that a victim of identity theft may request a copy of a return that was filed using his or her own information, though it may be heavily redacted. For example, in some cases, a fraudulent return may list multiple victims' information, and IRS should redact the other victims' return information before disclosing any of the victim's return information.

Legal Advice Issued by Field Attorneys 20171201F.

Taxpayer was on the hook for the employment taxes that were left unpaid by a professional employee organization (PEO). The taxpayer, not the PEO, was in control of the payment of wages to the individuals that worked in its business. Additionally, relief under Section 530 of the Revenue Act of 1978 did not apply because that provision deals only with controversies involving employment status of workers. However, the taxpayer was entitled to interest-free adjustments for underpayments under §6205(a)(1), to correct its "error" in relying on a PEO to pay its workers' payroll taxes.

In the operation of its limousine transportation business, Taxpayer employed workers to perform services in its accounting, administrative, marketing and sales departments. It also employed reservationists, fleet technicians, dispatchers, meeting and conference personnel, and chauffeurs. Taxpayer did not claim any deductions for officer compensation or salaries and wages. Instead, it claimed deductions for "Employee Leasing" for its entire workforce.

During the undisclosed tax years at issue, Taxpayer entered into agreements with a series of PEOs. Each PEO agreed to retain the individuals who worked at Taxpayer's location (the "co-employees"), and the parties agreed to share the responsibilities of being the employer of the co-employees. Taxpayer was the common law employer of the co-employees and had the right to direct and control all aspects of the employment relationship between itself and the workers.

In these arrangements, the PEO was obligated to (1) administer Taxpayer's payroll, designated benefits, and personnel policies and procedures related to the co-employees; (2) provide "Human Resource Administration and Payroll Administration"; (3) furnish and keep workers' compensation insurance covering the "co-employees" in force; and (4) and process and pay "co-employee" wages from its own accounts based on the hours reported by Taxpayer.

Taxpayer was required to determine and advise the PEO of the amount of hours worked by each employee, as well as the amount of wages to be paid to each employee at least one day prior to the end of the payroll period. Taxpayer was also required to remit an amount equal to the wages paid to employees, along with the employer's share of FICA and the requisite amount of FUTA taxes before the end of the payroll period, so that the PEO could meet the payroll requirements and pay the workers while withholding the corresponding amount of employment taxes. The contract also required Taxpayer to provide the PEO with a security deposit or a letter of credit equal to amounts to be paid on each payroll date, and allowed the PEO to terminate the agreement immediately in the event Taxpayer did not pay necessary amounts in full.

The PEOs were supposed to issue Forms W-2 to Taxpayer's common law employees, and report and pay employment tax relating to them on Form 941 (Employer's Quarterly Federal Return) and Form 940 (Employer's Annual Federal Unemployment (FUTA) Tax Return. However, the PEOs failed to use the money provided by Taxpayer to pay the employment tax liabilities to IRS, and IRS went after Taxpayer for the unpaid payroll taxes.

Observation: Unfortunate experiences like Taxpayer's led to the enactment, in the Tax Increase Prevention Act of 2014 (TIPA), of a rule that a "certified PEO" (and no other person) is to be treated as the employer liable for employment taxes with respect to wages paid by the certified PEO to a work site employee performing services for any customer of the certified PEO. TIPA required IRS to establish a certification program by July 1, 2015, which was to have been effective for wages paid on or after January 1, 2016. IRS needed additional time to set it up and delayed the date that it would begin accepting applications for PEO certification until July 1, 2016. In January of this year, IRS finally detailed the requirements for a certified PEO to remain certified and the procedures relating to suspension and revocation of certified PEO certification.

The principal issues raised in the LAFA are as follows.

Under §3401(d)(1), if the common law employer does not have control of the payment of wages, the term "employer" means the person having control of the payment of wages. Although the Code imposes only Federal income tax withholding obligations on the §3401(d)(1) employer, case law has extended such an employer's obligations to include withholding and payment of FICA and FUTA taxes. The key issue in determining whether a taxpayer is a §3401(d)(1) employer of employees leased to a client company is to establish whether the taxpayer was in control of the payment of wages to those employees.

In *Winstead* (1997, CA4) 79 AFTR 2d 97-1977, the taxpayer owned land that was farmed by sharecroppers, who were accountable for their hired help. However, the sharecroppers could not pay the hired help until after the crops were sold. Therefore, the taxpayer paid the help from his checking account, over which the sharecroppers had no authority, then deducted what he paid from the sharecroppers' share of the crop proceeds. The taxpayer was held to have control of the payment of wages to the hired help and thus to be the employer under §3401(d)(1). Similarly, in *In re Earthmovers Inc.,* (1996, Bktcy Ct FL) 78 AFTR 2d 96-6300, where an employer contracted with an employee leasing company to pay wages and payroll taxes but submitted information regarding the hours worked each week by each employee, forwarded amounts owed for payroll and taxes, and retained the right to hire and fire employees, the employer was not relieved of liability for taxes it owed. It was the employer bearing ultimate responsibility for wages and payroll taxes. The leasing company, however, was a de facto "co-employer," since by contract and local law it was also responsible for paying wages and payroll taxes. While the employer could contract out its responsibility for the payment of wages and payroll taxes, in the event of a default of this obligation by the leasing company, the employer was still responsible for wages and taxes owed to and on behalf of its employees.

Other cases have also held a leasing company is not a §3401(d)(1) employer when the leasing company received payroll information and funds from its client before the delivery of payroll to the client employees.

Taxpayer argued that it should be relieved of the liabilities at issue because the PEOs it used were the employer under §3401(d)(1), but the LAFA disagrees. Based on the provisions contained in the PEO contracts and Taxpayer's own admissions that at all times it remained the common law employer, the PEOs used by Taxpayer would not be treated as in control of the payment of wages within the meaning of §3401(d)(1). The PEOs assumed neither full nor complete responsibility for payment of the wages to the leased employees and, in fact, the contracts stated that in the event of termination for any reason whatsoever, Taxpayer was responsible for payment of all wages, salaries and employment-related taxes. Thus, the LAFA concludes that the PEOs acted merely as a conduit for each client company in making payroll and did not meet the standards established in the case law, so the PEOs used by Taxpayer were not considered the §3401(d)(1) employer.

Section 530 of the Revenue Act of 1978 (Section 530), as amended, provides that a taxpayer that incorrectly treats an employee as an independent contractor is nevertheless exempt from employment tax liability if it meets three requirements:

1. The taxpayer does not treat any other individual holding a substantially similar position as an employee for purposes of employment taxes for any period;

2. The taxpayer has consistently treated the worker as not being an employee for post-1978 periods, including by filing all required federal tax returns on a basis consistent with this treatment; and

3. The taxpayer has a reasonable basis for not treating the individual as an employee.

If all three Section 530 requirements are met, then for purposes of applying employment taxes for a particular tax period with respect to a taxpayer, "the individual shall be deemed not to be an employee." If the worker is deemed not to be an employee, then the taxpayer has no employment tax liability with respect to remuneration paid to that worker for that period.

The LAFA concludes that Taxpayer is not entitled to relief under Section 530. This provision focuses on the issue of whether the worker was an employee; the statutory language shows that it applies only to controversies involving employment status, and not questions of who remains liable when a third party payroll processing company fails to remit funds to the government on behalf of the common law employer. Additionally, other statutory language shows that Section 530 is limited to employment status controversies.

The legislative history of Section 530 also shows that Congress was providing a relief provision limited to employment status controversies regarding whether a worker was or was not an employee of the service recipient.

The LAFA concludes that Congress intended to limit the application of Section 530 relief only to employment status controversies regarding whether an individual should have been treated as an employee, not to whether a common lawyer employer remains ultimately liable for employment tax liabilities that were never paid by a PEO on its behalf.

While generally interest must be paid to IRS on any tax underpayment and to a taxpayer on any tax overpayment, an exception applies to employment taxes. Where an incorrect amount of tax under §3101 (employee Federal Insurance Contributions Act (FICA) tax), §3111 (employer FICA tax), §3201 (employee Railroad Retirement Tax Act (RRTA tax)), §3221 (employer RRTA tax), or §3402 (Federal income tax withholding (ITW)) is reported to IRS for any payment of wages or compensation, §6205(a)(1) allows employers to make interest-free adjustments for underpayments.

Regulation §31.6205-1(a)(1) provides that an employer who makes, or has made, an undercollection or underpayment of employee tax under §3101, §3111, §3201, §3221, or §3402 "shall correct such error" and that such correction shall constitute an interest-free adjustment. An error is ascertained when the employer has sufficient knowledge of the error to be able to correct it. (Regulation §31.6205-1(a)(4)) An interest-free adjustment may not be made after the earlier of receipt of notice and demand for payment based on an assessment or receipt of a Notice of Determination of Worker Classification (NDWC) under §7436.

In Taxpayer's case, since its reliance on a PEO to fulfill its employment tax obligations was in error, the LAFA concludes that if Taxpayer would be amenable to a binding resolution through the execution of agreed reports, then an offer of an interest-free adjustment with respect to the employment taxes would be a proper way to resolve the case.

The LAFA points out that the amount of interest that is compromised as a result of an interest-free adjustment may be significant, and often serves as an enticement to resolution before the issuance of an NDWC. Once a demand for payment of employment taxes is made subsequent to assessment or a NDWC is issued, taxpayers are no longer entitled to an interest-free adjustment. As such, the LAFA recommends that Taxpayer be told the monetary benefits of agreeing to enter into a full resolution of this case at the Appeals level, which would entitle Taxpayer to an interest-free adjustment.

Legal Advice Issued by Field Attorneys 20171801F.

While a person making a deposit may direct IRS to use the deposit as payment of any of his or her liabilities, Revenue Procedure 2005-18 does not authorize a person to direct IRS to apply a deposit to pay another person's liability. Further, IRS found that Form 2848 (Power-of-Attorney and Declaration of Representative) does not allow an attorney-in-fact to direct the transfer of a deposit to pay another's tax liability.

IRS classifies a remittance of taxes as either a payment or a deposit. If a tax remittance is determined to be a deposit, it is treated like a cash bond, which IRS simply holds, and a taxpayer may seek a refund of the deposit at any time. (*Rosenman v. U.S., (*S Ct 1945) 33 AFTR 314) But if a remittance is deemed a payment, the taxpayer may only recover the money by filing a timely claim for a refund. (*Miller v. U.S.,* (Fed Cl 11/9/2000) 86 AFTR 2d 2000-7058)

Under §6603(a), a taxpayer may make a deposit with IRS that may later be used to pay any tax that has not yet been assessed at the time of the deposit, but may later be imposed on the taxpayer. The amount of the deposit that is later used by IRS to pay tax is treated as a payment of tax at the time of the deposit, for purposes of determining whether the taxpayer owes interest on an underpayment of tax. (§6603(b))

Generally, IRS will return to the taxpayer any amount of the deposit (to the extent not used for a payment of tax) which the taxpayer requests in writing. (§6603(c))

§6603(a) provides that a taxpayer making a cash deposit with IRS must do so in the manner as prescribed by IRS. Revenue Procedure 2005-18, 2005-1 CB 798, sets out procedures for taxpayers to make, withdraw, or identify deposits to suspend the running of interest on potential underpayments, as §6603 permits.

Revenue Procedure 2005-18, §4.02, provides that a taxpayer may elect to have a deposit that exceeds the amount of tax ultimately determined to be due applied against another assessed or unassessed liability. For example, a taxpayer under examination for several different years may request that a deposit made for one type of tax in one year be applied to another type of tax in another year. The request must be in writing and must be directed to the same office where the original deposit was made.

Revenue Procedure 2005-18, §6.01, provides that a deposit made under §6603 is not subject to a claim for credit or refund as an overpayment until the deposit is applied by IRS as payment of an assessed tax of the taxpayer. A taxpayer may request the return of all or part of a deposit at any time before IRS has used the deposit for payment of a tax.

§6901(a) provides that the liability of a transferee of a taxpayer's property may be "assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred." It does not create or define a substantive liability, but merely provides IRS a procedure to assess and collect from the transferee of property the transferor's existing liability. The amount for which the transferee is liable is a direct function of how much was transferred to him by the transferor.

§6901 specifies the procedures by which IRS may administratively assert state law remedies for fraudulent transfers. While the procedures are federal, state substantive law controls in determining the existence and extent of transferee liability. (*Stern,* (S Ct 1958) 1 AFTR 2d 1899, *Frank Sawyer Trust of May 1992,* (CA 1 2013) 111 AFTR 2d 2013-1434)

The LAFA considers:

a. Whether a person making a deposit under §6603 for a potential transferee liability may direct IRS to apply all or a portion of its deposit against the liability of another person liable for same underlying liability; and

b. If a person making a deposit under §6603 can apply all or a portion of it to the liability of another person liable, whether an attorney-in-fact may direct IRS to transfer the deposit to pay another person's tax liability.

In the LAFA, IRS determined that the guidance issued to date (i.e., Revenue Procedure 2005-18) to administer §6603 does not authorize one depositor designating its deposit to be applied to another taxpayer's liability.

IRS reasoned that the liability of a transferee is derivative of the transferor's liability. Yet, while multiple transferees may be severally liable for the same liability of a transferor, it did not follow that the liability of the several transferees was the same liability. While it arose from the same taxpayer that may have made transfers in fraud of its creditors, it did not necessarily follow that the liability of one transferee was interchangeable with the liability of another. The bases for the liability quite often arose from different transactions between the transferor and the transferees.

Revenue Procedure 2005-18, §4.02(3), provides an example where one depositor can request that a deposit for one type of tax in one year be used to satisfy an underpayment of another type of tax for another year. But this is very different from a depositor requesting that its deposit be used to satisfy an underpayment of another taxpayer. Similarly, at Revenue Procedure 2005-18, §6.01, IRS notes that the deposit is not subject to a claim for credit or refund until it is applied by IRS as payment of an assessed tax of the taxpayer. That is, the taxpayer who makes the deposit can make a claim for credit or refund when it is applied by IRS as payment of an assessed tax of that taxpayer.

IRS also noted its concern over an attorney-in-fact being permitted to transfer funds from one taxpayer to another

IRS found that no mention is made in Form 2848 or its instructions of the permission of the representative to transfer §6603 deposits made by the transferee as one of the powers conveyed by Form 2848. In the absence of this specific power, IRS believed that there was not sufficient authority conveyed in the powers-of-attorney for IRS to follow the representative's instructions to transfer a deposit to another's liability.

Program Manager Technical Advice 2017-007.

IRS has clarified the scope of §6611(e)(4), which provides that the otherwise-applicable 45-day periods during which IRS does not have to pay interest on tax overpayments are extended to become 180-day periods with respect to overpayments resulting from tax deducted and withheld under Chapters 3 and 4 of the Code.

Chapter 3 of the Code (§1441 through §1464) requires withholding of tax on nonresident aliens and foreign corporations, while Chapter 4 of the Code (FATCA, §1471 to §1474) requires withholding on payments to foreign financial institutions and other foreign entities.

§6611(e) limits the amount of interest that accrues on overpayments under three different circumstances. First, §6611(e)(1) provides that no interest is allowed on an overpayment of tax claimed on a return if, in the case of a timely- or early-filed return, the overpayment is refunded during the 45-day period following the due date of the return or, in the case of a late-filed return, if the overpayment is refunded with 45 days of the date when the return was filed. Next, §6611(e)(2) provides that, when a taxpayer files a claim for refund and IRS refunds the overpayment within 45 days of the claim, no interest is allowed on the overpayment for a period beginning on the date that the claim for refund was filed. Finally, §6611(e)(3) provides that, where an IRS-initiated adjustment results in an overpayment, interest on that overpayment is computed by subtracting 45 days from the number of days for which interest on the overpayment would otherwise be allowed.

§6611(e)(4) extends the 45-day periods described in §6611(e)(1), §6611(e)(2), and §6611(e)(3) to 180 days "in the case of any overpayment resulting from tax deducted and withheld under chapters 3 or 4."

The PMTA considers whether the extended 180-day period applies to all overpayments of amounts withheld pursuant to Chapters 3 and 4-including those that arise as a result of net operating losses (NOLs) carried back from subsequent tax years-or whether there are some overpayments of Chapter 3 and 4 withholding to which the standard 45-day interest suspension period applies.

The PMTA concludes that §6611(e)(4) 's extended grace period was intended to apply broadly to all overpayments of amounts withheld under Chapters 3 and 4, and not merely to some subset of claims for refund of Chapter 3 and 4 withholding.

The PMTA noted that IRS has not issued any regulations, revenue rulings, or revenue procedures concerning §6611(e)(4) and that no court has yet considered its scope or meaning. The legislative history of §6611(e)(4) is also very limited. The only explanation of §6611(e)(4) in the legislative history is in the Joint Committee on Taxation's Technical Explanation, i.e., Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the Hiring Incentives to Restore Employment Act, Under Consideration by the Senate (JCX-4-10), February 23, 2010.

The PMTA then said that its conclusion was based on the fact that the committee report does not describe any limitations on the extended grace period, or any refunds of Chapter 3 or 4 withholding to which §6611(e)(4) does not apply. The PMTA also noted:

a. As the Treasury inspector general for tax administration (TIGTA) noted in a 2010 report about the need to improve processes for issuing refunds to nonresident aliens, IRS requested that it be given 180 days rather than 45 days to process a return without interest in order to give IRS more time to verify withholding before issuing refunds of amounts reported as having been withheld.

b. The Joint Committee report also noted, in its more general discussion of refunds and credits of Chapter 3 and 4 withholding, that claims for refunds may be made by nonresident aliens on the basis of a tax treaty. The PMTA said that IRS may need additional time under these circumstances as well, to determine whether any treaty provision entitles the taxpayer to a refund.

c. And, IRS's concern about verifying withholding before issuing a refund is applicable regardless of the basis for the claim for refund (e.g., an NOL carried back from a subsequent year, deductions in the current year, or income exempted by treaty from U.S. taxation).

IR 2017-102.

As originally announced by IRS in June of this year, after August 15, 2017, the Pay.gov electronic payment website will become the only permissible payment method for the fees that taxpayers must pay when they request letter rulings, closing agreements, and certain other rulings from IRS.

In January of each year, IRS issues a Revenue Procedure that sets out rules for private letter rulings, closing agreements and determination letters. The annual Revenue Procedure sets out the fees that must be paid by taxpayers who wish to obtain the letter rulings, etc. The most recent such Revenue Procedure is Revenue Procedure 2017-1, 2017-1 IRB 1.

Pay.gov is a way to make electronic payments to Federal government agencies. Many common forms of payment are accepted, including credit cards, debit cards, and direct debit or electronic funds withdrawal from a checking or savings account.

In June 2017, in IR 2017-102, IRS announced that, while up until then ruling requesters could only make required user fee payments by check or money order, during a 2-month transition period, June 15 to August 15, requesters would be able to choose to make user fee payments either through Pay.gov or by check or money order. It also announced that, after August 15, 2017, Pay.gov will become the only permissible payment method.

Rulings described in Revenue Procedure 2017-1 and sent to the Docket, Records and User Fee Branch of the Legal Processing Division of the Associate Chief Counsel (Procedure and Administration) are affected by these changes. These include private letter rulings, closing agreements, and rulings using Forms 1128 (Application to Adopt, Change or Retain a Tax Year), 2553 (Election by a Small Business Corporation), 3115 (Application for Change in Accounting Method), or 8716 (Election to Have a Tax Year Other Than a Required Tax Year). Determination letters are not affected because they are sent to other offices as described in the Revenue Procedure.

Pay.gov is used to accept payments only. The original, signed ruling request and supporting materials must still be submitted by mail or hand delivery.

To submit a user fee, visit http://www.pay.gov and use the "IRS Chief Counsel User Fees (or Supplemental User Fees) for Form 1128, Form 2553, Form 3115, Form 8716, Private Letter Rulings and Closing Agreements" form. This form can be found by entering "IRS Chief Counsel User Fees" in the "Search the Forms" box or by clicking on the "Agency List" link under "What Federal Agencies Can I Pay?" and choosing "Internal Revenue Service."

Once payment is made, a taxpayer should print a copy of the completed form and the receipt and include these with the letter ruling request. IR 2017-102 provides a mailing address and an address for hand delivery or private courier service delivery.

IR 2017-109.

IRS announced that it is now accepting renewal applications for the Individual Taxpayer Identification Numbers (ITINs) set to expire at the end of 2017. IRS urged taxpayers affected by changes to the ITIN program to submit their renewal applications as soon as possible to avoid an anticipated rush.

Any individual filing a U.S. tax return is required to state his or her taxpayer identification number on that return. Generally, a taxpayer identification number is the individual's Social Security number (SSN). However, in the case of individuals who are not eligible to be issued an SSN, but who still have a tax filing obligation, IRS issues ITINs for use in connection with the individual's tax filing requirements. (Regulation §301.6109-1(d)(3)(i))

The Protecting Americans from Tax Hikes (PATH) Act (P.L. 114-113), enacted late in 2015, made a number of changes to the ITIN program, including providing that ITINs that have not been used on a federal tax return at least once in the last three consecutive years will expire December 31, 2017, and ITINs with middle digits 70, 71, 72 or 80 will also expire at the end of the year. (§6109(i)(3)(B)(ii)) Affected taxpayers who expect to file a tax return in 2018 must submit a renewal application.

ITINs with middle digits of 78 and 79 already expired last year. Taxpayers with these ITIN numbers can renew at any time.

In the News Release, IRS reminded taxpayers that they can now begin submitting ITIN renewal applications. Taxpayers whose ITIN is expiring and who need to file a tax return in 2018 must submit a renewal application. While Federal returns that are submitted in 2018 with an expired ITIN will be processed, exemptions and/or certain tax credits will be disallowed. Taxpayers will receive a notice in the mail advising them of the change to their tax return and their need to renew their ITIN. Once the ITIN is renewed, any applicable exemptions and credits will be restored and any refunds will be issued.

In the News Release, IRS also advised that an ITIN with the middle digits 70, 71, 72, or 80 (For example: 9NN-70-NNNN; NNN-71-NNNN; 9NN-72-NNNN; 9NN-80-NNNN) need to be renewed even if the taxpayer has used it in the last three years. IRS will begin sending the CP-48 Notice (You must renew your Individual Taxpayer Identification Number (ITIN) to file your U.S. tax return) later this summer to affected taxpayers. The CP-48 Notice explains the steps to take to renew the ITIN if it will be included on a U.S. tax return filed in 2018. Taxpayers who receive the notice after taking action to renew their ITIN do not need to take further action unless another family member is affected .

Taxpayers with an ITIN with middle digits 70, 71, 72 or 80 have the option to renew ITINs for their entire family at the same time. Those who have received a renewal letter from IRS can choose to renew the family's ITINs together even if family members have an ITIN with middle digits other than 70, 71, 72 or 80. Family members include the tax filer, spouse and any dependents claimed on the tax return.

To renew an ITIN, a taxpayer must complete a Form W-7 (Application for IRS Individual Taxpayer Identification Number) and submit all required documentation. Taxpayers submitting a Form W-7 to renew their ITIN are not required to attach a federal tax return. However, taxpayers must still note a reason for needing an ITIN on the Form W-7. IRS began accepting ITIN renewals on June 21.

The application package can be submitted in three ways:

1. By mail, along with original identification documents or copies certified by the agency that issued them, to the address listed on the Form W-7 instructions. IRS will review the identification documents and return them within 60 days;

2. By working with a Certified Acceptance Agent (CAA), who is authorized by IRS to help taxpayers apply for an ITIN. CAAs review all documentation for a taxpayer and certify that the application is correct before submitting it to IRS for processing. CAAs can also certify passports and birth certificates for dependents, saving taxpayers from having to mail original documents to IRS; and

3. By making an appointment at a designated IRS Taxpayer Assistance Center in lieu of mailing original identification documents to IRS.

IRS advised that several common errors can slow down and hold up some ITIN renewal applications. The mistakes generally center on missing information and/or insufficient supporting documentation. IRS urges any applicant to check over their form carefully before sending it to IRS.

IRS also reminded taxpayers that it no longer accepts passports that do not have a date of entry into the U.S. as a stand-alone identification document for dependents from a country other than Canada or Mexico, or dependents of U.S. military personnel overseas. The dependent's passport must have a date of entry stamp, otherwise the following additional documents to prove U.S. residency are required: U.S. medical records for dependents under age 6; U.S. school records for dependents under age 18; and U.S. school records (if a student), rental statements, bank statements or utility bills listing the applicant's name and U.S. address, if over age 18.

To increase the availability of ITIN services nationwide, particularly in communities with high ITIN usage, IRS is actively recruiting CAAs, and applications are now accepted year-round.

Notice 2017-38, 2017-30 IRB.

Treasury Department has described its review of significant tax regulations as directed by President Trump's Executive Order 13789 and has identified the regulations potentially qualifying for burden reduction.

On April 21, 2017, President Trump issued Executive Order 13789 which instructed the Treasury Secretary to review all "significant tax regulations" issued on or after January 1, 2016, and submit two reports, followed promptly by concrete action to alleviate the burdens of regulations that meet criteria outlined in the order.

The Treasury Secretary, in consultation with the Administrator of the Office of Information and Regulatory Affairs, was to submit a 60-day interim report identifying regulations that: (1) impose an undue financial burden on U.S. taxpayers; (2) add undue complexity to the Federal tax laws; or (3) exceed IRS's statutory authority. The Treasury Secretary was directed to submit a final report to the President by September 18, 2017, recommending "specific actions to mitigate the burden imposed by regulations identified in the interim report."

From January 1, 2016, through April 21, 2017, Treasury and IRS issued 105 temporary, proposed, and final regulations. During this time period, Treasury and IRS issued one regulation-under §385 -that the Office of Management and Budget designated as "significant" pursuant to Executive Order 12866 (an earlier order on regulatory review; for more extensive background. Executive Order 13789 provides, however, that in determining whether a regulation is significant for the purpose of this review, past determinations made pursuant to Executive Order 12866 are not controlling.

53 of the 105 regulations issued during the relevant review period are minor or technical in nature and generated minimal public comment. Treasury treated the remaining 52 regulations as potentially significant and reexamined all of them for the purpose of formulating the interim report.

Based on that reexamination, Treasury has identified regulations that meet the criteria of the President's order and qualify as significant in view of the Presidential priorities for tax regulations outlined in Executive Order 13789.

Treasury concluded that the following eight regulations meet at least one of the first two criteria specified by Section 2 of Executive Order 13789. Consistent with the order, Treasury intends to propose reforms-potentially ranging from streamlining problematic rule provisions to full repeal-to mitigate the burdens of the following regulations in a final report submitted to the President.

1. Proposed §103 regulations (REG-129067-15) on the definition of a "political subdivision" of a State (e.g., a city or county) that is eligible to issue tax-exempt bonds for governmental purposes. The proposed regulations would require a political subdivision to possess three attributes: (i) sovereign powers; (ii) a governmental purpose; and (iii) governmental control.

   Commenters stated that (a) the long-standing "sovereign powers" standard was settled law and had been endorsed by Congress, and additional limitations were unnecessary; and (b) the proposed regulations would disrupt the status of numerous existing entities and would be burdensome and costly for issuers to revise their organizational structures to meet the new requirements.

2. Temporary §337(d) regulations (T.D. 9770) on certain transfers of property to regulated investment companies (RICs) and real estate investment trusts (REITs), which would amend existing rules on transfers of property by C corporations to REITs and RICs generally. The regulations would also provide additional guidance on certain newly-enacted provisions of the Protecting Americans from Tax Hikes (PATH) Act of 2015 that were intended to prevent certain spin-off transactions involving transfers of property by C corporations to REITs from qualifying for nonrecognition treatment.

   Commenters expressed concern that the REIT spin-off rules could result in over-inclusion of gain in some cases, particularly where a large corporation acquires a small corporation that engaged in a §355 spin-off and the large corporation subsequently makes a REIT election.

3. Final §7602 regulations (T.D. 9778) on the participation of a person described in §6103(n) in a Summons Interview, which would provide that persons described in §6103(n) and Regulation §301.6103(n)-1(a) with whom IRS contracts for services-such as outside economists, engineers, consultants, or attorneys-may receive books, papers, records, or other data summoned by IRS and, in the presence and under the guidance of an IRS officer or employee, participate fully in the interview of a person who IRS has summoned as a witness to provide testimony under oath.

   Commenters objected to IRS's ability to contract with outside attorneys and allow them to question witnesses under oath, and the U.S. Senate Finance Committee approved legislation in 2016 that would prohibit IRS from delegating to third-party contractors the authority under §7602. Treasury will review these regulations as they concern the outside attorneys under contract with IRS to participate in the taking of compulsory testimony under oath.

4. Proposed §2704 regulations (REG-163113-02) on restrictions on liquidation of an interest for estate, gift and generation-skipping transfer taxes. §2704(b) provides that certain non-commercial restrictions on the ability to dispose of or liquidate family-controlled entities should be disregarded in determining the fair market value of an interest in that entity for estate and gift tax purposes. The proposed regulations would create an additional category of restrictions that also would be disregarded in assessing the fair market value of an interest.

   Commenters expressed concern that (a) the proposed regulations would eliminate or restrict common discounts, such as minority discounts and discounts for lack of marketability, which would result in increased valuations and transfer tax liability that would increase financial burdens; (b) the proposed regulations would make valuations more difficult; and (c) that the proposed narrowing of existing regulatory exceptions was arbitrary and capricious.

5. Temporary §752 regulations (T.D. 9788) on liabilities recognized as recourse partnership liabilities which generally would provide: (i) rules for how liabilities are allocated under §752 solely for purposes of disguised sales under §707; and (ii) rules for determining whether "bottom-dollar

payment obligations" provide the necessary "economic risk of loss" to be taken into account as a recourse liability.

Commenters: (1) stated that the first rule was novel and would unduly limit the amount of partners' bases in their partnership interests for disguised sale purposes, which would negatively impact ordinary partnership transactions; and (2) were concerned that the bottom-dollar payment obligation rules would prevent many business transactions compared to the prior regulations and suggested their removal or the development of more permissive rules.

6. Final and temporary §385 regulations (T.D. 9790) on the treatment of certain interests in corporations as stock or indebtedness, which address the classification of related-party debt as debt or equity for federal tax purposes. The regulations are primarily comprised of (i) rules establishing minimum documentation requirements that ordinarily must be satisfied in order for purported debt among related parties to be treated as debt for federal tax purposes; and (ii) transaction rules that treat as stock certain debt that is issued by a corporation to a controlling shareholder in a distribution or in another related-party transaction that achieves an economically similar result.

   Commenters to the documentation rules: (1) criticized the financial burdens of compliance, particularly with respect to more ordinary course transactions; and (2) requested a longer delay in the effective date. Commenters to the final transaction rules criticized the complexity associated with tracking multiple transactions through a group of companies and the increased tax burden imposed on inbound investments.

7. Final §987 regulations (T.D. 9794) on income and currency gain or loss with respect to a §987 qualified business unit, which would provide rules for (i) translating income from branch operations conducted in a currency different from the branch owner's functional currency into the owner's functional currency, (ii) calculating foreign currency gain or loss with respect to the branch's financial assets and liabilities, and (iii) recognizing such foreign currency gain or loss when the branch makes a transfer of any property to its owner.

   Commenters objected that: (1) the transition rule in the final regulations imposes an undue financial burden on taxpayers because it disregards losses calculated by the taxpayer for years prior to the transition but not previously recognized; and (2) the method prescribed by the final regulations for calculating foreign currency gain or loss was unduly complex and costly to comply with, particularly where the final regulations differ from financial accounting rule.

8. Final §367 regulations (T.D. 9803) on the treatment of certain transfers of property to foreign corporations. §367 generally imposes immediate or future U.S. tax on transfers of property (tangible and intangible) to foreign corporations, subject to certain exceptions. The final regulations eliminate the ability of taxpayers under prior regulations to transfer foreign goodwill and going concern value to a foreign corporation without immediate or future U.S. income tax.

   Commenters objected that (1) the final regulations would increase burdens by taxing transactions that were previously exempt, noting in particular that the legislative history to §367 contemplated an exception for outbound transfers of foreign goodwill and going concern value; and (2) an exception should be provided for transfers of foreign goodwill and going concern value in circumstances that would not lead to an abuse of the exception.

Treasury is requesting comments on whether these regulations should be rescinded or modified, and in the latter case, how the regulations should be modified in order to reduce burdens and complexity.

November 4, 2016 letter from IRS Appeals Chief Kirsten Wielobob.

In response to concerns from the practitioner community about various issues relating to IRS's Office of Appeals, Appeals Chief Kirsten Wielobob wrote a letter to clarify the effect of certain recent changes and correct a number of erroneous speculations that had been made about Appeals.

Settlement authority of front-line employees. In July of 2015, the Treasury Inspector General for Tax Administration (TIGTA) issued a report on the Penalty Appeals workstream that highlighted the lack of consistent review of cases by managers. The report cited as a significant control weakness the absence of any limit on the amount of penalties that Appeals and Settlement Officers could abate without managerial review and concluded that this created a high level of risk for improper abatements.

Appeals' leadership then studied whether the control weakness (i.e., front-line employees having settlement authority without required managerial review) existed in any other Appeals workstream and identified one: the Appeals Team Case Leader (ATCL) Operations. After conducting a risk assessment, Appeals concluded that it would modify existing procedures by allowing the ATCLs to retain settlement authority but making it clear that a manager must review a case prior to an ATCL finalizing a settlement.

Conference participation by IRS employees. IRS recently revised IRM 8.6.1.4.4, "Participation in Conferences by IRS Employees." Ms. Wielobob noted that she had heard comments that this provision was added to force taxpayers to use an early resolution technique similar to a process called "Rapid Appeals Process" (RAP; described in IRM 8.26.11 as an elective dispute resolution method designed to improve efficiency and timeliness of Appeals resolutions). She clarified that Appeals always had the discretion to permit other IRS employees to attend conferences to aid in case resolution and that it does not reflect any intent to force a particular resolution technique on taxpayers.

Conference practices; availability of in-person option. IRS recently revised its in-person conference practices, effective October 3, 2016, to clarify its procedures, better allocate resources, and "get the right work to the right Appeals employee." However, Ms. Wielobob noted in her letter that the revisions resulted in a misconception that taxpayers needed to request an in-person conference in order to take full advantage of the appeals process.

Ms. Wielobob clarified that Appeals is continuing to offer personal contact for all cases and in-person conferences where Appeals determines that such will aid in resolving cases, and that taxpayers will continue to have a range of conference options depending on the nature of their case-telephone, correspondence, in-person, etc. However, contrary to past practice, Appeals will no longer grant in-person conferences solely upon taxpayer request.

Review of §9100 relief denials. Also, effective October 3, IRS revised its policies regarding Section 9100 relief determinations (in general, extensions to make regulatory elections). The decision to grant taxpayers Section 9100 relief is left to the Commissioner's discretion, which has been delegated to the Office of Chief Counsel and not to Appeals.

Appeals concluded that it should not accept cases where a taxpayer is challenging a 9100 relief determination made by the Office of Chief Counsel because, even if it reverses the decision, it lacks authority to grant the extension sought. Appeals reasoned that its decision cannot bring the result that a taxpayer wants in requesting the appeal and that it potentially creates confusion in tax administration for it to accept those cases. Appeals reached a similar conclusion with respect to denials of taxpayers' applications to change accounting methods (i.e., that it cannot change the method so should not accept these cases).

IRS Small Business/Self Employed Division Memo "Interim Guidance on use of Frequently Asked Questions (FAQs) and other items posted to IRS.gov" (May 18, 2017).

IRS's Small Business/Self Employed Division (SB/SE) has issued a memorandum to its Field Examination Area Directors that provides that frequently asked questions (FAQs) and other items posted on IRS.gov that have not been published in the Internal Revenue Bulletin (IRB), are not legal authority.

IRS makes frequent postings to its website, IRS.gov. In many cases, these postings are in the form of FAQs. And, in many cases, the items posted to IRS.gov are not reproduced, or are not fully reproduced, in pronouncements that form part of the IRB.

SB/SE has issued a memorandum that instructs its auditors on how to treat items posted on IRS.gov.

The memorandum states that it is the policy of IRS to publish in the IRB all substantive rulings necessary to promote a uniform application of the tax laws, including rulings that supersede, revoke, modify, or amend any of those previously published in the IRB.

IRS employees must follow items published in the IRB, and taxpayers may rely on them. Some items, such as FAQs, can be found on IRS.gov but have not been published in the IRB. FAQs that appear on IRS.gov but that have not been published in the IRB are not legal authority and should not be used to sustain a position unless the items (e.g., FAQs) explicitly indicate otherwise or IRS indicates otherwise by press release or by notice or announcement published in the IRB.

IRS said that the memorandum is effective on the date it was issued, May 18, 2017.

LB&I International Practice Unit, "The Meaning of "Substantially Complete" with Reference to International Information Return Penalties" (June 19, 2017).

In an International Practice Unit (IPU), IRS discusses the meaning of the phrase "substantially complete" for purposes of evaluating whether certain international information returns are sufficient to avoid penalties under §6038 and §6038A. The IPU noted that the phrase id not defined in statute or regulations, and provided a survey of the limited informal guidance available, but stated that the substantial compliance doctrine may be used to supplement the existing guidance or suggest a "general approach" that an agent may take in the absence of other guidance.

Observation: IPUs are not official IRS pronouncements of law or directives and cannot be used, cited, or relied upon as such. Nonetheless, they identify strategic areas of importance to IRS and can provide valuable insight as to how IRS examiners may audit a particular issue or transaction.

Under §6038, certain U.S. persons who are officers, directors, or shareholders in certain foreign corporations must file an information return with respect to each foreign corporation and foreign partnership "controlled" by them. With respect to foreign corporations, the U.S. person must file Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations."

Under §6038A, a U.S. corporation that is "25% foreign-owned" (in general, 25% owned by a single foreign shareholder) must furnish certain information to IRS. The form used to satisfy this requirement is Form 5472, "Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business."

A taxpayer that is required to but fails to file one of the above forms by the due date and in the manner prescribed may be subject to penalties under §6038(b) and §6038A(d). However, Regulation §1.6038-2(k)(3)(ii) provides that a taxpayer may be relieved from liability for the penalty if IRS determines the taxpayer "substantially complied" with §6038 's reporting requirements. Similarly, Regulation §1.6038A-4(a)(1) provides that a taxpayer who files a "substantially incomplete" return is subject to penalty, but that a taxpayer may be relieved from liability if the IRS determines that such taxpayer "substantially complied" with §6038A 's reporting requirements. (Neither "substantially incomplete" nor "substantially complied" are defined in the regulations, although a number of items of non-precedential advice have been issued)

The IPU noted that, in determining whether a tax return satisfies a reporting requirement or whether a taxpayer has complied with a statute or regulatory requirement, there are two standards that may apply: strict compliance and substantial compliance. In determining which standard applies, courts may consider whether the particular information or requirement at issue goes to the "substance or essence" of the statute or regulation, in which case strict compliance is necessary, or whether the requirement is "procedural or directory," in which case substantial compliance may apply.

With respect to a return, the IPU outlined the so-called "Beard" test, under which a tax return will generally be considered valid (i.e., will satisfy the substantial compliance doctrine) for purposes of beginning the statute of limitations on assessment if: (i) it provides sufficient data to calculate tax liability, (ii) the document purports to be a return; (iii) there has been an "honest and reasonable attempt" to satisfy tax law requirements; and (iv) it is signed under penalties of perjury. (*Beard,* (1984) 82 TC 766, aff'd (CA 6 1986) 58 AFTR 2d 86-5290)

With respect to elections, the IPU analyzed several Tax Court cases and generally observed that when taxpayers fail to strictly comply with certain requirements that do not go to the "substance" of the election itself but are rather, for instance, to provide information that is helpful to IRS, the doctrine of substantial compliance will often apply. (See, e.g., *Taylor,* (1977) 67 TC 1071, where taxpayers followed the rules relating to an election but failed to include a statement; and Bond, (1993) 100 TC 32, where certain information was not provided on the taxpayer's return but was later given to IRS upon request.)

IRS noted, as a general matter, that strict compliance generally applies to statutory requirements whereas substantial compliance generally applies to regulatory requirements.

For substantial compliance purposes, the IPU notes the distinction between income tax returns and information returns, observing that each serves a different purpose. Information reported on income tax returns is generally necessary to determine tax liability; but if a taxpayer omits information that is not necessary to determine tax liability, the return may be considered complete notwithstanding the omission. Information returns, however, are required so IRS can "properly administer the revenue laws." Thus, an omission can impede IRS's ability to perform its duties.

With respect to international information returns, the IPU states that "Congress's intent in requiring taxpayers to report the information required to be reported on international information returns was to give the IRS more information about foreign entities with U.S. ties so that the IRS could determine if U.S. tax laws are being properly observed."

Congress enacted §6038 and §6038A, which provide penalties for the failure to provide information in regard to (a) controlled corporations and partnerships and (b) certain foreign-owned corporations, respectively.

As noted above, IRS issued regulations under §6038 providing that a taxpayer may be relieved from liability for the penalty if IRS determines that such taxpayer "substantially complied" with the reporting requirements of §6038. Regulations under §6038A provide that a taxpayer who files a "substantially incomplete" return is subject to penalty, but that a taxpayer may be relieved from liability for the penalty if the IRS determines that such taxpayer "substantially complied" with the reporting requirements of §6038.

The quoted terms above are not defined in the Code or regulations. The IPU surveyed several items of non-precedential advice issued on the meaning of "substantially complete" as applied to international information returns, deriving the following guidelines from each:

a. In considering a situation where a U.S. taxpayer accurately reported the majority of the information on its Form 5471 but failed to accurately report major transactions with related parties, IRS determined that failure to accurately provide the information required by §6038 may result in returns that are considered incomplete, even if most of the information on the form is correct. (Field Service Advice 33381431) IRS rejected the taxpayer's argument that it should adopt an "aggregate approach" under which a taxpayer would be considered to be in substantial compliance if it accurately reported a certain percentage of the information required to be reported on the Form 5471.

b. In considering whether a Form 5472 was "substantially complete" in a number of different factual scenarios, IRS applied a two-prong test that evaluated the magnitude of the errors and the effect of the noncompliance on IRS's ability to efficiently audit the information required by the statute and regulations. (Chief Counsel Advice 200429007) The CCA provided seven factors to consider in making such a determination.

c. In considering whether Forms 5471 filed by a U.S. taxpayer were substantially complete, IRS found that the taxpayer's failure to submit financial statements in the manner required constituted an omission of "significant pieces of required information" and that such did not reflect an "isolated oversight" but rather an "intentional decision to file incomplete Forms 5471." (Chief Counsel Advice 200645023)

VI. 21st Century Cures Act

§18001 (Exception From Group Health Plan Requirements for Qualified Small Employer Health Reimbursement Arrangements) of H.R. 34, the 21st Century Cures Act.

On December 13, President Obama signed into law the "21st Century Cures Act" (the Act). In addition to providing a medical innovation package that funds medical research, accelerates cutting-edge treatments for rare diseases, and makes significant reforms to the mental health system, the Act also allows small employers to provide Health Reimbursement Arrangements (HRAs) to their employees without facing penalties for failing to satisfy certain Affordable Care Act (ACA) requirements. The Act also extends relief previously granted under Notice 2015-17, to apply to plan years beginning on or before December 31, 2016.

Small Employer HRAs Exempted from Group Health Plan Requirements

HRAs are arrangements under which an employer agrees to reimburse medical expenses (as defined in §213(d) -including health insurance premiums) up to a certain amount per year, with unused amounts available to reimburse medical expenses in future years. The reimbursement is excludable from the employee's income.

HRAs generally are considered to be group health plans for purposes of the Code, Employee Retirement Income Security Act of 1974 (ERISA), and the Public Health Service Act (PHS Act), provisions of which were incorporated into the Code by the ACA.

The ACA contains certain market reforms that generally apply to group health plans ("group health plan requirements"), including the following provisions:

1. PHS Act §2711, which provides in part that a group health plan (or a health insurance issuer offering group health insurance coverage) may not establish any annual limit on the dollar amount of benefits for any individual.

2. PHS Act §2713, which requires non-grandfathered group health plans (or health insurance issuers offering group health insurance plans) to provide certain preventive services without imposing any cost-sharing requirements for these services (the preventive services requirements).

IRS distinguishes between employer-funded HRAs that are "integrated" with other coverage as part of a group health plan (which can meet the PHS Act §2711 annual limit rules) and HRAs that are not so integrated, i.e., "stand-alone" HRAs (which cannot meet the PHS Act §2711 lifetime and annual limit rules). Similarly, IRS says a stand-alone HRA would not meet the PHS Act §2713 preventive services requirement. (Notice 2013-54, 2013-40 IRB 287)

§4980D imposes an excise tax on any failure of a group health plan (including a stand-alone HRA) to meet the Code's group health plan requirements.

The ACA's complex employer-shared responsibility provisions apply only to applicable large employers (ALEs), defined for 2016 as employers that employed an average of at least 50 full-time employees (including full-time equivalent employees) on business days during the preceding year.

Employers, whether or not they are ALEs, are subject to the §4980D excise tax if they maintain group health plans that do not meet the ACA market reform requirements.

Thus, under pre-Act law, after June 30, 2015, small employers that maintain a stand-alone HRA could be liable for the §4980D excise tax.

New law. The Act provides that a "qualified small employer HRA" is not treated as a group health plan for income tax purposes (except for §4980I(f)(4) (which defines a group health plan), as amended, and notwithstanding any other provision of the Code). (§9831(d)(1), as amended by Act §18001(a)) There are similar exceptions for ERISA and PHS Act purposes. (Act §18001(b) and (c)).

Observation: Thus, under the Act, a qualified small employer HRA will not face the §4980D excise tax levied on group health plans that do not meet the ACA market reform requirements.

A qualified small employer HRA is one that satisfies the following requirements:

1. It is maintained by an eligible employer. (§9831(d)(2)(A)(ii)) An eligible employer is an employer that is not an ALE as defined in §4980H(c)(2) - i.e., it employs fewer than 50 employees - and does not offer a group health plan to any of its employees. (§9831(d)(3)(B))

2. It is provided on the same terms to all eligible employees. (§9831(d)(2)(A)(ii)) An eligible employee is any employee of an eligible employer, except that the arrangement may exclude from consideration employees who have not completed 90 days of service, employees who have not attained age 25, part-time or seasonal workers, employees covered in a collective bargaining unit, and certain nonresident aliens. (§9831(d)(3)(A))

3. It is funded solely by an eligible employer, and no salary reduction contributions may be made under the HRA. (§9831(d)(2)(B)(i))

4. It provides, after the employee provides proof of coverage, for the payment of, or reimbursement of, an eligible employee for expenses for medical care (as defined in §213(d)) incurred by the eligible employee or the eligible employee's family members (as determined under the HRA's terms) (§9831(d)(2)(B)(ii)) and

5. The amount of payments and reimbursements do not exceed $4,950 ($10,000 in the case of an arrangement that also provides for payments or reimbursements for family members of the employee). (§9831(d)(2)(B)(iii)) For any year beginning after 2016, the above dollar amounts are subject to cost of living increases. (§9831(d)(2)(D)(ii)) For employees who are covered by a qualified arrangement for less than an entire year, the above dollar amounts are prorated. §9831(d)(2)(D)(i))

An arrangement will not fail to be treated as provided on the same terms to each eligible employee merely because the employee's permitted benefit under such arrangement varies in accordance with the variation in the price of an insurance policy in the relevant individual health insurance market based on- (i) the age of the eligible employee (and, in the case of an arrangement which covers medical expenses of the eligible employee's family members, the age of such family members), or (ii) the number of family members of the eligible employee the medical expenses of which are covered under such arrangement. (§9831(d)(2)(C))

The term "permitted benefit" means, with respect to any eligible employee, the maximum dollar amount of payments and reimbursements which may be made under the terms of the qualified arrangement for the year with respect to such employee. (§9831(d)(3)(C))

Effective date. The exemption of small employer HRAs from the group health plan requirements is generally effective for years beginning after December 31, 2016. (Act §18001(a)(7)(A))

Extension of Relief under Notice 2015-17

Notice 2015-17, 2015-10 IRB 845, provided relief from the §4980D excise tax for any failure to satisfy the market reforms by "employer payment plans" that pay, or reimburse employees for, individual health policy premiums or Medicare part B or Part D premiums (1) for 2014, for employers that are not ALEs for 2014, and (2) for January 1 through June 30, 2015, for employers that are not ALEs for 2015. Under Notice 2015-17, an employer payment plan is a group health plan under which an employer reimburses an employee for part of all of his health insurance premium expenses, or pays the premium expenses directly.

New law. The Act treats Notice 2015-17 as applying to any plan year beginning on or before December 31, 2016. (Act §18001(a)(7)(B))

Observation: Thus, for plan years beginning on or before December 31, 2016, employer payment plans (as defined by Notice 2015-17) that are maintained by employers that are not ALEs-that is, by small employers with fewer than 50 employees-will not face the §4980D excise tax.

Small Employer HRA Reporting & Notice Requirements

§6652 imposes penalties for failure to file certain information returns and registration statements. §6051(a) requires W-2 reporting of compensation subject to either FICA tax or income tax withholding. Some amounts required to be reported under that section include amounts contributed to Archer Medical Savings Accounts, amounts contributed to health savings accounts, and the value of applicable employer-sponsored health insurance coverage.

New law. A small employer funding a qualified HRA for any year must, not later than 90 days before the beginning of such year (or, in the case of an employee who is not eligible to participate in the arrangement as of the beginning of such year, the date on which such employee is first so eligible), provide a written notice to each eligible employee which includes (i) a statement of the amount of the employee's permitted benefit under the arrangement for the year; (ii) a statement that the eligible employee should provide the information described in clause (i) to any health insurance exchange to which the employee applies for advance payment of the premium assistance tax credit; (iii) a statement that if the employee is not covered under minimum essential coverage for any month, the employee may be subject to tax under §5000A (i.e., the individual mandate) for such month, and reimbursements under the arrangement may be includible in gross income. (§9831(d)(4), as added by Act §18001(a)(1))

If an employer fails to provide the required notice, unless such failure is shown to be due to reasonable cause and willful neglect, the employer will be subject to a $50 per-employee, per-incident-of-failure penalty, subject to a $2,500 calendar year maximum for all such failures. (§6652(o), as added by Act. §18001(a)(5))

Employers also have to report the total amount of permitted benefit under §9831(d)(3)(C) for the year under a qualified arrangement on their employees' W-2s. (§6051(a)(15), as added by Act §18001(a)(6))

Effective date. The notice and reporting requirements are effective for years beginning after December 31, 2016. (Act §18001(a)(7)(A)) The §6652(o) penalty applies to notices with respect to years beginning after December 31, 2016; however, the Act provides transition relief for §6652(o) under which a person will not be treated as failing to provide a written notice as required under §9831(d)(4) if such notice is provided not later than 90 days after the date of the Act's enactment. (Act §18001(a)(7)(D))

The W-2 reporting requirements apply to calendar years beginning after December 31, 2016. (Act §18001(a)(7)(E))

Limitation on Exclusion from Gross Income

§106 provides that an employee 's gross income does not include employer-provided coverage under an accident or health plan that compensates that employee for the personal injuries or sickness of the employee, the employee's spouse, or dependents.

New law. Under a newly added provision, for purposes of §105 (Amounts received under accident and health plans) and §106 (Contributions by employer to accident and health plans), payments or reimbursements from a qualified small employer HRA of an individual for medical care (as defined in §213(d)) will not be treated as paid or reimbursed under employer-provided coverage for medical expenses under an accident or health plan if, for the month in which such medical care is provided, the individual does not have minimum essential coverage under §5000A(f). (§106(g), as added by Act §18001(a)(2))

Effective date: This treatment of payments and reimbursements is effective for years beginning after December 31, 2016. (Act §18001(a)(7)(A))

Coordination with Premium Tax Credit Provisions

§36B(a) provides a premium tax credit to eligible taxpayers who enroll in a qualified health plan, or have a spouse or dependent enrolled in a qualified health plan, through a Marketplace. A taxpayer is generally only allowed a premium tax credit if his or her household income is at least 100% and not more than 400% of the Federal poverty line (FPL) for the taxpayer's family size.

A taxpayer's premium tax credit with respect to any coverage month is the lesser of: (a) the premiums for the plan or plans in which the taxpayer or one or more members of the taxpayer's family enroll and (b) the excess of the premiums for the applicable second lowest cost silver plan covering the taxpayer's family over the taxpayer's contribution amount. (§36B(b)(2)) A taxpayer's contribution amount is the product of the taxpayer's household income and an "applicable percentage" that increases as the taxpayer's household income increases.

§36B(c)(2)(B) provides that a coverage month does not include any month with respect to an individual if, for such month, the individual is eligible for minimum essential coverage other than eligibility for coverage in the individual market described in §5000A(f)(1)(C). Under §36B(c)(2)(C), an individual is not treated as eligible for employer-sponsored minimum essential coverage if the required contribution with respect to the plan exceeds 9.5% of the taxpayer's household income.

§1411 of the ACA provides procedures for determining the eligibility of an individual for Exchange participation, premium tax credits and cost-sharing reductions (Exchange subsidies), and exemptions from the individual mandate. §1411(b)(3) specifically provides the information that an enrollee claiming an Exchange subsidy must provide to the Exchange-generally, information on income and family size, as well as on any changes in circumstances that would affect eligibility.

New law. For any month that an employee is provided a small employer HRA that constitutes affordable coverage, the employee is not eligible for a premium assistance tax credit under §36B. (§36B(c)(4)(A), as amended by Act §18001(a)(3)) The Act sets out a definition for "affordable" for this purpose, and also contains provisions for when an employee is provided a qualified small employer HRA for less than an entire year. (§36B(c)(4)(C))

The Act also provides that an Exchange subsidy applicant must provide to the Exchange the amount of the enrollee's permitted benefit under a qualified small employer HRA. (Act §18001(a)(6)(B))

Effective date: The rule making certain employees with small employer HRAs ineligible for premium assistance tax credits is effective for tax years beginning after December 31, 2016. (Act §18001(a)(7)(C)) The rule requiring information to be provided to an Exchange generally applies to applications for enrollment made after December 31, 2016, but transition relief applies. (Act §18001(a)(7)(F))

Application of "Cadillac" Tax

For tax years beginning after December 31, 2019, a 40% excise tax will apply to "applicable employer-sponsored coverage" that provides an "excess benefit"-generally, high cost employer-sponsored health plans. The tax is known as the "Cadillac tax." "Applicable employer-sponsored coverage" generally means, with respect to any employee, coverage under group health plan made available to the employee by an employer which is excludable from the employee's gross income under §106.

The definition of a "group health plan" is provided in §4980I(f)(4) via reference to §5000(b)(1).

New law. The Act amends §4980I(f)(4) by providing that §9831(d)(1) (i.e., the exclusion from group health plan treatment for small employer HRAs) does not apply for purposes of the Cadillac tax. In determining the cost of a small business HRA, the cost of coverage is equal to the amount described in §6051(a)(15) (i.e., the amount reported on the employee's W-2). (§4980I(f)(4), as amended by Act §18001(a)(4))

Effective date. The provision on the application of the Cadillac tax is effective for years beginning after December 31, 2016. (Act §18001(a)(7)(A))

VII. H.R. 3823, the "Disaster Tax Relief and Airport and Airway Extension Act of 2017."

On September 29, President Trump signed into law P.L. 115-63, the "Disaster Tax Relief and Airport and Airway Extension Act of 2017." The Act, which had been passed by Congress the day before, provides temporary tax relief to victims of Hurricanes Harvey, Irma, and Maria. Businesses that qualify for relief may claim a new "employee retention tax credit" of up to $2,400 for qualified wages paid to eligible employees. Relief for individuals includes, among other things, loosened restrictions for claiming personal casualty losses, tax-favored withdrawals from retirement plans, and the option of using current or prior year's income for purposes of claiming the earned income and child tax credits.

Casualty Loss Rules

Current law. A taxpayer generally may claim a deduction for any loss sustained during the tax year and not compensated by insurance or otherwise. (§165(a)) For individuals, a personal loss from a casualty is deductible only to the extent that (1) it exceeds $100, and (2) all casualty losses (after application of the $100-floor) for the tax year exceed 10% of adjusted gross income (AGI). (§165(h)) If the disaster occurs in a federally declared disaster area, the taxpayer may elect to take into account the casualty loss in the tax year immediately preceding the tax year in which the disaster occurs. (§165(i)) The deduction for casualty losses is an itemized deduction.

New law. The Act provides special rules for taxpayers that suffer a "net disaster loss" for any tax year. The Act defines a net disaster loss as the excess of "qualified disaster-related personal casualty losses" over personal casualty gains, as defined in §165(h)(3)(A) .

Qualified disaster-related personal casualty losses, are losses described in §165(c)(3) that arise:

1. In the Hurricane Harvey disaster area (note there is a distinction between "areas" and "zones") on or after August 23, 2017, and which are attributable to Hurricane Harvey;

2. In the Hurricane Irma disaster area on or after September 4, 2017, and which are attributable to Hurricane Irma;

3. In the Hurricane Maria disaster area on or after September 16, 2017, and which are attributable to Hurricane Maria. (Act Sec. 504(b)(3))

For purposes of the Act, a disaster "zone" means the portion of the disaster area determined by the President to warrant individual or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of the disaster. A disaster "area" means an area with respect to which a major disaster has been declared by the President by reason of the disaster. (Act Sec. 501(a))

For taxpayers claiming a net disaster loss, the Act eliminates the current law requirement that personal casualty losses must exceed 10% of AGI to qualify for a deduction. (Act Sec. 504(b))
The Act also eliminates the current law requirement that taxpayers must itemize deductions to access this tax relief for losses. The taxpayer’s standard deduction under §63(c) is increased by the net disaster loss. (Act Sec. 504(b)(1)(C))

The Act provides that §56(b)(1)(E) , which generally disallows the standard deduction for alternative minimum tax (AMT) purposes, does not apply for the portion of the standard deduction attributable to the net disaster loss. (Act Sec. 504(b)(1)(D))

In addition, the Act increases the $100 per-casualty floor to $500 for qualified disaster-related personal casualty losses. (Act Sec. 504(b)(1)(B))

Access to Retirement Funds

Current law. A loan from a qualified employer plan to a participant or beneficiary is treated as a plan distribution unless, among other things: (i) the loan amount does not exceed the lesser of: (A) $50,000, or (B) half of the present value of the employee's nonforfeitable accrued benefit under the plan (however, a loan up to $10,000 is allowed, even if it's more than half the employee's accrued benefit) (§72(p)(2)(A)); and (ii) the loan is required to be repaid within five years, (§72(p)(2)(B)(i)) except that a longer repayment can be used for a principal residence plan loan. (§72(p)(2)(B)(ii))

Early (generally, pre-age 59 1/2) withdrawals from a qualified retirement plan result in regular tax plus an additional tax equal to 10% of the amounts withdrawn that are includible in gross income. (§72(t)(1)) The additional tax applies unless the taxpayer qualifies for one of several specific exceptions. (§72(t)(2) ; §72(t)(3))

New law. The Act relaxes a number of rules to allow victims to make "qualified hurricane distributions" from their retirement plans of up to $100,000 (less any prior withdrawals treated as "qualified hurricane distributions"; Act Sec. 502(a)(2)(A)).

The Act defines a "qualified hurricane distribution" as any distribution from an eligible retirement plan, as defined in §402(c)(8)(B) (which includes IRAs), made:

1. On or after August 23, 2017, and before January 1, 2019, to an individual whose principal place of abode on August 23, 2017, is located in the Hurricane Harvey disaster area and who has sustained an economic loss by reason of Hurricane Harvey;

2. On or after September 4, 2017, and before January 1, 2019, to an individual whose principal place of abode on September 4, 2017, is located in the Hurricane Irma disaster area and who has sustained an economic loss by reason of Hurricane Irma; and

3. On or after September 16, 2017, and before January 1, 2019, to an individual whose principal place of abode on September 16, 2017, is located in the Hurricane Maria disaster area and who has sustained an economic loss by reason of Hurricane Maria. (Act Sec. 502(a)(4)

Significantly, the Act excepts qualified hurricane distributions from the 10% early retirement plan withdrawal penalty. (Act Sec. 502(a)(1))

The Act allows taxpayers to spread out any income inclusion resulting from such withdrawals over a 3-year period, beginning with the year that any amount is required to be included (or elect out). (Act Sec. 502(a)(5))

The Act also allows the amount distributed to be re-contributed at any time over a 3-year period beginning on the day after the distribution was received. (Act Sec. 502(a)(3)(B)) If re-contributed to a eligible retirement plan other than an IRA, the taxpayer is treated as having received the qualified hurricane distribution in an eligible rollover distribution (as defined in §402(c)(4)) and as having transferred the amount to an eligible retirement plan in a direct, trustee-to-trustee transfer within 60 days of the distribution. (Act Sec. 502(a)(3)(B)) If recontributed to an IRA, the qualified hurricane distribution is treated as a §408(d)(3) distribution that is transferred to an eligible retirement plan in a direct trustee to trustee distribution within 60 days of the distribution. (Act Sec. 502(a)(3)(C))

Observation: The net effect is that a timely recontribution will allow the taxpayer to recoup the tax he paid on the qualified hurricane distribution (or avoid it entirely if the repayment is made in the same year as the distribution). For example, if a plan participant receives a qualified hurricane distribution in 2017 he will pay regular tax on it (spread out over 3 years) but not the 10% penalty tax. If he recontributes the qualified hurricane distribution amount in 2018, he may file an amended return and get a refund of the tax he paid on his 2017 return for the distribution.

For purposes of the withholding rules under §3405 , qualified hurricane distributions are not treated as eligible rollover distributions (which, unless certain requirements are met, are otherwise subject to 20% withholding under §3405(c)(1)(B)). (Act Sec. 502(a)(6)(A))

The Act also allows for the recontribution of certain retirement plan withdrawals for home purchases or construction, which were received after February 28, 2017 and before September 21, 2017, where the home purchase or construction was cancelled on account of Hurricane Harvey, Irma, or Maria. (Act Sec. 502(b))

A timely recontribution avoids tax on the plan withdrawal. The recontribution must be made during the period beginning on August 23, 2017, and ending on February 28, 2018.

With respect to retirement plan loans, the Act:

1. Increases the maximum amount that a participant or beneficiary can borrow from a qualified employer plan under §72(p)(2)(A) , from $50,000 to $100,000; (Act. Sec. 502(c)(1))

2. Removes the "one half of present value" limitation; (Act Sec. 502(c)(1)) and

3. Allows for a longer repayment term, if the due date for any repayment with respect to the loan occurs during a qualified beginning date that is Hurricane-specific and ends on December 31, 2018, by delaying the due date of the first repayment by one year (and adjusting the due dates of subsequent repayments accordingly). (Act Sec. 502(c)(2)(A))

Charitable Deduction Limitations Suspended

Current law. An individual who itemizes can deduct charitable contributions up to 50%, 30% or 20% of AGI, depending on the type of property contributed and the type of donee). (§170(b)(1)) A corporation generally can deduct charitable contributions up to 10% of its taxable income. (§170(b)(2)) Amounts that exceed the ceilings ("excess contributions") can be carried forward for five years by both individuals and corporations, subject to various limitations and ordering rules. (§170(d)) For individuals, charitable contributions are deductible only as an itemized deduction. (Regulation §1.170A-1(a))

New law. For qualifying charitable contributions associated with qualified hurricane relief, the Act:

1. Temporarily suspends the majority of the limitations on charitable contributions in §170(b)

2. Provides that such contributions will not be taken into account for purposes of applying §170(b) and §170(d) to other contributions;

3. Provides eased rules governing the treatment of excess contributions; and

4. Provides an exception from the overall limitation on itemized deductions for certain qualified contributions.

"Qualified contributions" must be paid during the period beginning on August 23, 2017, and ending on December 31, 2017, in cash to an organization described in §170(b)(1)(A) , for relief efforts in the Hurricane Harvey, Irma, or Maria disaster areas. (Act Sec. 504(a)(4)) Qualified contributions must also be substantiated, with a contemporaneous written acknowledge that the contribution was or is to be used for relief efforts (Act Sec. 504(a)(4)(A)(ii)), and the taxpayer must make an election for Act. Sec. 504(a) to apply. (Act Sec. 504(a)(4)(A)(iii) For partnerships and S corporations, the election is made separately by each partner or shareholder. (Act Sec. 504(a)(4)(C))

Employee Retention Tax Credit for Employers

Current law. Certain business incentive credits are combined into one general business credit (GBC) for purposes of determining each credit's allowance limitation for the tax year. A GBC (claimed on Form 3800) is allowed against income tax for a particular tax year and equals the sum of: (1) the business credit carryforwards carried to the tax year, (2) the current year GBC, and (3) the business credit carrybacks carried to the tax year. (§38(a)) A list of the component credits of the current year business credit is provided in §38(b .

New law. The Act provides a new "employee retention credit" for "eligible employers" affected by Hurricanes Harvey (Act Sec. 503(a)), Irma (Act Sec. 503(b)), and Maria (Act Sec. 503(c)). Eligible employers are generally defined as employers that conducted an active trade or business in a disaster zone as of a specified date (for Hurricane Harvey, August 23, 2017; Irma, September 4, 2017; and Maria, September 16, 2017), and the active trade or business of which was, on any day between the specified date and January 1, 2018, rendered inoperable as a result of damage sustained by the hurricane.

In general, the credit is be treated as a credit listed in §38(b) , and equals 40% of up to $6,000 of "qualified wages" with respect to each "eligible employee" of such employer for the tax year.

Observation: Thus, the maximum credit per employee is $2,400 ($6,000 × 40%).

An eligible employee with respect to an eligible employer is one whose principal place of employment with the employer was in Hurricane Harvey, Irma, or Maria disaster zone.

Qualified wages mean wages (as defined in §51(c)(1) but without regard to §3306(b)(2)(B)) paid or incurred by an eligible employer with respect to an eligible employee on any day after the specified date (above) and before January 1, 2018, which occurs during the period: (i) beginning on the date on which the employer's trade or business first became inoperable at the principal place of employment of the employee immediately before the respective hurricane, and (ii) ending on the date on which such trade or business has resumed significant operations at such principal place of employment.

Qualified wages include wages paid without regard to whether the employee performs no services, performs services at a different place of employment than such principal place of employment, or performs services at such principal place of employment before significant operations have resumed. An employee cannot be taken into account more than one time for purposes of the employee retention tax credit. If an employee is an eligible employee of an employer with respect to Hurricane Harvey for purposes of the credit, the employee cannot also be an eligible employee of the employer with respect to Hurricane Irma or Hurricane Maria. (Act Secs. 503(a)(4), (b)(4), and (c)(4))

The Act also provides that rules similar to §51(i)(1) (which disallows the work opportunity tax credit, or WOTC, when the employee is considered "related" to the employer) and §52 (which provides rules for apportioning the WOTC among commonly controlled businesses) apply. (Act Secs. 503(a)(3), (b)(3), and (c)(3))

Special Rule on "Earned Income" for EITC & CTC Purposes

Current law. Under §32, an eligible individual is allowed an earned income tax credit (EITC) equal to the credit percentage of earned income (up to an "earned income amount") for the tax year. For 2017, the earned income amount is $6,670 for taxpayers with no qualifying children, $10,000 for those with one qualifying child, and $14,040 for those with two or more qualifying children.
For purposes of the EITC, earned income includes wages, salaries, tips, and other employee compensation, but only if those amounts are includible in gross income for the tax year; plus net earnings from self-employment less the §164(f) deduction for half of self-employment tax for the year. (§32(c)(2)(A))

Under §24 individuals can claim a $1,000 child tax credit (CTC) for each qualifying child the taxpayer can claim as a dependent. The child must be under 17 and a U.S. citizen or resident alien. (§24(c)) The amount of the allowable credit is reduced (not below zero) by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income (AGI increased by excluded foreign, possession, and Puerto Rico income) above: $110,000 for joint filers, $75,000 for unmarried individuals, and $55,000 for married taxpayers filing separately. (§24(b)) To the extent the CTC exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit equal to 15% percent of earned income in excess of a threshold dollar amount. (§24(d))

New law. The Act provides that, in the case of a "qualified individual," if the earned income of the taxpayer for the tax year which includes the applicable date (i.e., the dates shown in the following paragraph) is less than the taxpayer's earned income for the preceding tax year, then the taxpayer may, for purposes of the EITC and CTC, substitute the earned income for the preceding year for the earned income for the tax year that includes the applicable date. (Act Sec. 504(c)(1)) If the election is made, it applies for both §24(d) and §32 purposes.

For Hurricane Harvey, a "qualified individual" is one whose principal place of abode on August 23, 2017 was located either in the Hurricane Harvey disaster zone, or in the Hurricane Harvey disaster area and the individual was displaced from their principal place of abode by reason of Hurricane Harvey. Similar definitions apply for Hurricane Irma (using a September 4, 2017 date) and Hurricane Maria (using a September 16, 2017 date). (Act Sec. 504(c)(2))

In the case of joint filers, the above election may apply if either spouse is a qualified individual. (Act Sec. 504(c)(5)

This document was compiled from a number of sources using information released through October 16, 2017. Important events and information released after that date are included in the Supplement and is updated through October 31, 2017.

IMPORTANT NOTICE PLEASE READ

Every effort has been made to offer the most current, correct, and clearly expressed information possible in the preparation of this outline. Nonetheless, inadvertent errors can occur, and tax rules and Regulations often change. The information in this outline is intended to afford general guidelines on the matters discussed. However, the application and impact of tax laws and financial matters can vary widely from case to case based on the specific or unique facts involved. Accordingly, the information in this outline is not intended to serve as legal, accounting, or tax advice. Readers are encouraged to conduct their own independent research of the matters discussed in this outline. The author disclaims any responsibility for positions taken by taxpayers in their individual cases or for any misunderstanding on the part of readers.

This information was compiled from various professional tax research services including general internet sources, underlying Court and Treasury documents, RIA, CCH, Tax Analysts and BNA. No authorship is claimed on my part.

As always, I want to thank Martha Gensecke who has been my typist for at least 19 years. Martha, you are the best!

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