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TAX SECTION
STATE BAR OF TEXAS

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Dear Fellow Tax Section Members:

Fall is here and despite some the challenges of 2020, the Tax Section continues full steam ahead! With all of the tax law changes, I suspect that most of us are busier than a moth in a wool mitten! If you haven't had a chance to reach out and help others during these trying times, please don't forget that the CARES Act has provided a great incentive to give to public charities by allowing taxpayers who don't itemize deductions to take a charitable deduction of up to $300 for cash contributions made in 2020 to qualifying organizations. If you haven't yet taken advantage of this tax break, don't miss out on your chance to do so by the end of the year. After all, every great tax attorney loves a tax break!

Thank you to our new Texas Tax Lawyer editor, Aaron Borden, who has put together this edition of the Texas Tax Lawyer. We hope you benefit from the informative and interesting articles included in this edition.

Tax Section Annual Meeting

In case you missed it, the Tax Section held its Annual Meeting and CLE program on Friday, June 26th. The Tax Section was honored to have IRS Commissioner Charles P. Retting as a speaker. In addition, John Strohmeyer and Matthew Myers spoke on Pre-Immigration Tax Planning. Bill Elliot continued his Texas Tax Legends series with a wonderful interview of Emily A. Parker. We had remarkable "attendance" at our virtual meeting and are hopeful that the format allowed many who would not have been able to travel to the meeting to attend in the comfort of their own home or office. Thank you to everyone who worked so diligently to make the online format such a success!

Next year's Annual Meeting is scheduled to take place on Friday, June 18, 2021. Whether the meeting occurs in person in Fort Worth as planned or online, the Tax Section is again planning a half-day format so that members can take advantage of offerings from other sections, including the plenary luncheon if we are in person. There is sure to be an outstanding line up, so please mark your calendars and plan to attend!

Planning for the 2020-2021 Section Year

The new officers met via Zoom on August 5, 2020 to begin planning for the year. In addition, the Officers, Council, and Committee Chairs and Vice Chairs met on September 11, 2020. There was much discussion about how to continue to offer networking and Continuing Legal Education to Tax Section members during these interesting times.

International Tax Symposium

Due to extenuating circumstances, the 23rd International Tax Symposium has been postponed until 2021.

First Wednesday Tax Update

Bruce McGovern, Professor of Law and Director, Tax Clinic, South Texas College of Law Houston, continues to provide his popular monthly tax update, with monthly attendance that regularly exceeds 100 Tax Section members. In November, Professor McGovern welcomed guest speakers Laurel Stephenson, Tax Section Council Member, Davis Stephenson, PLLC and Shannon Bonn Weber, Davis Stephenson, PLLC, to present on the SECURE Act. Professor McGovern will return in December. There will be no presentation in January due to the holiday break.

Below are some important reminders about the Monthly Update.

- The registration link is sent via eblast about a week before the first Wednesday of the month.
- The registration link can also be found at the Texas Tax Section website a week before the update.
- A member cannot sign up for the update once the live broadcast has begun.
- If for any reason you do not receive the eblast, you can register by going to the Texas Tax Section website.
- Members are now required to self-report their CLE credit as we are unable to report on your behalf due to the virtual nature of the presentation. The CLE number will be provided in both an email to all registrants and at the end of the update.
- The recorded program is posted online in the 24/7 Library about 2 weeks after the live program. Members can log in to the Texas Tax Section website to watch it for CLE credit.

Annual Comptroller Briefing

Planning for the Tax Section's Annual Comptroller Briefing in 2021 is underway. Stay tuned for more information.

Additional Online CLE programming

A very special thank you to Council Members Abbey Garber and Audrey Morris for their outstanding presentation "Zooming into Tax Court" on September 29, 2020. Audrey and Abbey brought in the first two litigants in Texas to try a case in Tax Court online. These litigants shared invaluable insights into how to best utilize the technology and made suggestions to ensure everything runs smoothly. The program is now available in the 24/7 Library.

The Tax Section is planning to offer its members additional online CLE programming this year. The State and Local Tax Committee is planning quarterly SALT updates that should be available soon. In addition, a new state property tax virtual presentation is in the planning stages.

If you have suggestions for topics of interest for future presentations, please contact [me](#) or any member of the [CLE Committee](#) of the Tax Section.

Tax Law in Day

Tax Law in a Day is a seminar specifically designed to provide information on a wide variety of basic tax topics. Renesha Fountain, Tax Section Council member, and Harriet Wessel are planning Tax Law in a Day, which is scheduled as a virtual meeting over two days, February 4 and 5, 2020. If you are interested in presenting a CLE during that program or have suggestions for topics or speakers, please reach out to [Renesha or Harriet](#).

Committee on Government Submissions

The Committee on Government Submissions continues its work under the leadership of Sam Megally, Jason Freeman, and Josh Prywes.

On October 5, 2020, the Committee submitted comments to the Internal Revenue Service regarding the Proposed Regulations relate to Section 1061 of the Code. This project was the result of great collaboration among several committees. The principal drafters of the comments were Lee S. Meyercord and Nathan T. Smithson, Co-Chairs of the Partnership and Real Estate Tax Committee, Andrew E. Botts, Brandon L. Bloom, Todd Lowther, Julia Pashin, and Jeff Wallace, members of the Partnership and Real Estate Tax Committee, and Carol G. Warley, Chair of the Estate and Gift Tax Committee. Mary A. McNulty, past Chair of the Tax Section and member of the Partnership and Real Estate Tax Committee, also reviewed the Comments and provided substantive suggestions. The comments are included in this edition.

On November 9, 2020, the Committee provided comments to the Texas Comptroller of Public Accounts on draft proposed 34 Tex. Admin. Code § 3.340, concerning Qualified Research, and draft proposed 34 Tex. Admin. Code § 3.599, concerning Margin: Research and Development Activities Credit. The principal drafters of the comments were Stephen Long and Matt Hunsaker, Co-Chairs of the State and Local Tax Committee, and William J. LeDoux, Vice-Chair of the SALT Committee. Ira Lipstet, member of the SALT Committee, and Sam Megally, COGS chair, also reviewed the comments and provided substantive suggestions.

The work of the COGS committee continues to ensure that new regulatory provisions work as intended and any inconsistencies can be corrected before the finalization of the regulations and rules. This is a meaningful service to our profession and to the public in general. I commend all Tax Section members who have worked so hard in this meaningful endeavor.

Law School Outreach

The Law School Outreach Committee is responsible for visiting each law school in Texas to give a behind-the-scenes view of a tax attorney. This program has transitioned to online scholarships to law students intending to practice tax law in Texas. Applications will be available in January 2021.

Pro Bono Committee

The Tax Section's Tax Court Pro Bono program for both Tax Court trial sessions and settlement days in advance of the trial sessions have been held virtually. Because of our robust program, we also participated by request in tax court proceedings in Nevada and Florida. The taxpayer in Florida who was unable to obtain local pro bono assistance was referred to our program by a Tax Court Judge. Our work in this area is widely known and recognized.

The section is also planning to participate in the Adopt-a-Base program again this year, however details for participation have not yet been finalized by the military. If you are interested in participating in these worthy endeavors or have any questions, please contact a member of the Pro Bono Committee. The work of this committee is some of the most meaningful work we can do for the public. All lawyers who assist in these projects have earned my highest regard.

Contact Information

Please feel free to contact me or our Tax Section Administrator, Anne Schwartz, if you have any questions or would like additional information about any of these items or the Tax Section in general. Please be safe and well for the balance of 2020!

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TAX SECTION
STATE BAR OF TEXAS

2021
CALL FOR NOMINATIONS FOR OUTSTANDING TEXAS TAX LAWYER AWARD

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

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

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

Nominations should be submitted to Henry Talavera, Tax Section Secretary by email to htalavera@polsinelli.com no later than April 1, 2021.

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

NOMINATION FOR 2021 OUTSTANDING TEXAS TAX LAWYER AWARD

Nominee Name: ____

Nominee Mailing Address, Phone, and Email:

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

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Nominator Name: ____

Nominator Mailing Address, Phone, and Email:

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Back from the Dead:

The Return of the NOL Carryback: a discussion of the effect and tax planning opportunities created by the CARES Act.[1]

By Harold "Hap" May CPA, JD, LLM (Tax)[2]

Introduction

Generally federal income tax is calculated by taking net income within a twelve-month period. For most individuals that is a calendar year. For corporations that twelve months could be a calendar year, or it could be a fiscal year. The income of most taxpayers varies from year to year. Some taxpayer's income varies to the point that the taxpayer has significant gains in some years and significant losses in other years. The federal government will collect its share of tax in years which a taxpayer has positive income. However, in years that a taxpayer's expenses and other deductions exceed the taxpayer's gross income the government does not share in that loss. The U.S. Government is a taxing authority not a business partner.

The Internal Revenue Code (the "Code") does provide some relief from the rather harsh general rule that taxes are calculated only in a single year. For years in which a taxpayer experiences a loss from the operations of a business or other income earning activity the taxpayer's Net Operating Loss ("NOL") is calculated. The detailed NOL calculation will be discussed later, but generally this is the amount by which allowable deductions exceed the

[1] This article and any related presentation are for educational purposes only and are not intended to establish an attorney-client relationship or provide legal advice. To ensure compliance with requirements imposed by the I.R.S., the author informs you that any discussion of U.S. Federal Tax contained in this communication along with any attachments is not intended or written to be used, and cannot be used for the purpose of: 1) avoiding penalties under the Internal Revenue Code, as amended or 2) promoting, marketing, or recommending to another party any transaction or tax-related matter.

[2] The author would like to thank South Texas College of Law Houston student Joe McCormack for his tireless research efforts in the development of this article.

includable gross income in a particular year. The year in which a taxpayer has a NOL is referred to as a "Loss Year."

Under the Code, the NOL can be used as a deduction in years other than the year the loss occurred. The rules as to what years the NOL can be used have changed several times. Prior to the Tax Cuts and Jobs Act of 2017 ("2017 Tax Act") a NOL could be carried back two years and carried forward 20 years.[3] The 2017 Act eliminated the carryback but made the carryforward eligible for an unlimited amount of years.[4] The 2017 Act also limited the amount of a taxpayer's NOL deduction to 80% of the current year's income.[5]

While carryforwards do provide some potential future tax benefit, what benefits there are not immediate and may be is contingent on there being future income that the NOL deduction can be used to offset. By contrast, a taxpayer with a history of taxable profits that experiences a Loss Year can complete a few extra forms to carryback the NOL to a profitable year and obtain a cash refund as it prepares its Loss Year tax return. Thus, in this situation a NOL carryback is of more benefit to the taxpayer and likely to have a more stimulating effect for the economy.

Many business and tax planners mourned the 2017 death of the NOL carryback. But behold the miracle of resurrection! In response to the economic shutdown caused by the COVID-19 Pandemic, Congress unanimously passed The Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") and President Trump signed it into law on March 27, 2020.[6] The CARES Act is an upwards of two trillion-dollar aid and stimulus package that has many

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[3] John Owsley, CPA, Ph.D., and John McKinley, CPA, CGMA, J.D., LL.M. *Carry Your Losses (Further) Forward*, J. OF ACCOUNTANCY (May 1, 2018), https://www.journalofaccountancy.com/issues/2018/may/carry-forward-net-operating-losses.html.
[4] I.R.C. § 172(b)(1)(A)(ii)(II).
[5] *See* Owsley, *supra* note 3.
[6] *The CARES Act Works for All Americans,* U.S. DEPT. OF THE TREAS., https://home.treasury.gov/policy-issues/cares (last visited June 12, 2020).

functions.[7] While most of the CARES Act's provisions are well beyond the scope of this article, there is one provision that is a game changer for taxpayers that have or will experience losses in the years 2018 through 2020.

The CARES Act revived the NOL carryback so that Net Operating Losses that occur in years 2018, 2019 and 2020 can be carried backed for up to five years. Many taxpayers that lost money in 2018 and 2019 will immediately be eligible for refunds. Additionally, because of the disruption caused by COVID-19[8] and the economic shut down[9] that followed, a significant number of taxpayers will have large NOLs in taxable year of 2020.

In addition to the certainty of losses during the shutdown, for the year 2020 taxpayers have the remaining months to plan. Taxpayers that had profits in the years 2015 through 2019 will be looking to maximize their losses and take full advantage of the resurrected NOL carryback. These taxpayers will be looking for ways to recognize losses that might otherwise be recognized in future years or perhaps never be recognized.

The first section of this article will discuss what a Net Operating Loss is and how it occurs. The second section will discuss which taxpayers may utilize a NOL. The third section will highlight 1) the concept of a carryback and carryforward, 2) the formula for which calculating a NOL reflecting the limitations placed on a taxpayer's ability to deduct certain items, and 3) the limitations restricting a taxpayer's ability to carry a NOL backwards or forward. The fourth section will discuss the forms, process and tax planning opportunities

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[7] Kelsey Snell, *What's Inside The Senate's $2 Trillion Coronavirus Aid Package*, NPR, (March 26, 2020), https://www.npr.org/2020/03/26/821457551/whats-inside-the-senate-s-2-trillion-coronavirus-aid-package.
[8] *Coronavirus*, WORLD HEALTH ORGANIZATION, https://www.who.int/health-topics/coronavirus#tab=tab_1 (last visited June 13, 2020).
[9] *State Shutdowns Have Taken at Least a Quarter of U.S. Economy Offline*, WALL ST. J., https://www.wsj.com/articles/state-coronavirus-shutdowns-have-taken-29-of-u-s-economy-offline-11586079001 (last visited June 14, 2020).

including the types of transactions that a taxpayer may wish to engage in prior to December 31, 2020.

The COVID-19 Effect

The COVID-19 pandemic had an unprecedented effect on the U.S. economy. In the tax year 2020, many businesses are likely to have significant operating losses.[10] That is a natural consequence of an unplanned shut down of the US economy.[11] The types of businesses that come to mind when thinking about 2020 losses at first thought are restaurants[12] and oil companies[13] to name just a few. That said, the wide ripple effect that the pandemic has had on the economy will mean many businesses in almost every industry will experience losses in 2020. For businesses and individuals that have a history of taxable income for the last five years, these 2020 losses could turn into cash refunds thanks to the resurrection of NOL carrybacks.

In addition to the natural losses that come in a year with a significant economic downturn, some tax planning can enhance the amount of applicable tax losses and the refund associated with a loss carryback. It will be important to maximize losses in 2020 because the NOL carryback provision in the CARES Act expires so that a loss after 2020 can only be carried forward.

The list of legitimate tax planning techniques that a taxpayer can utilize to recognize a loss in a given tax year is long and well beyond the scope of this article. However, for the purposes of hypothetical examples, imagine:

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[10] *P/C Insurers Put a Price Tag on Uncovered Coronavirus Business Interruption Losses*, INS. J., https://www.insurancejournal.com/news/national/2020/03/30/562738.htm (last visited June 14, 2020).
[11] *Id.*
[12] Edward Ludlow, *One-Quarter of American Restaurants Won't Reopen, OpenTable Says*, BLOOMBERG, https://www.bloomberg.com/news/articles/2020-05-14/one-quarter-of-american-restaurants-won-t-reopen-opentable-says (May 14, 2020).
[13] Hailey Waller, *Oil Dives the Most in Six Weeks, Exposing Fragile Recovery*, BLOOMBERG, https://www.bloomberg.com/news/articles/2020-06-10/oil-drops-as-record-high-u-s-stockpiles-add-to-economic-worries (June 10, 2020).

1) A retailer has excess inventory that will ultimately sell for a loss. Engaging in a sale liquidating that inventory prior to year-end will allow the loss to be taken in 2020.

2) A cash basis taxpayer pays all accounts payable prior to year-end. The payments could be subject to a deduction in the year paid.

3) An accrual basis business is suing a customer that has not paid a significant account. If the business accepts a settlement offer from the customer for half of the amount owed to the business, the business will have a recognizable loss. If the settlement can be completed by year-end, the loss will be deductible in 2020 and could result in a tax refund.[14]

4) An accrual basis taxpayer is being sued. The taxpayer cannot take a deduction so long as the taxpayer denies liability.[15] If the taxpayer settles the suit and agrees to make payments, the taxpayer likely would be entitled to a deduction.[16] This deduction may be taken in the year of settlement if certain tests are met.[17]

Additionally, the 2017 Act limited the casualty loss deduction to areas declared as natural disasters.[18] On March 13, 2020, President Trump issued an unprecedented nationwide disaster

[14] *See* I.R.C. § 451(b)(1)(C). (discussing the all events test for gross income inclusion).
1) If all the events have occurred which fix the right to receive such income and
2) the amount of such income can be determined with reasonable accuracy.
See also § 165 (describing deductions allowed for business losses).

[15] Treas. Reg. § 1.461-1(a)(2) (1960). The taxpayer must satisfy the all events test to take a deduction.
1) All events have occurred giving rise to the liability have occurred,
2) liability amount can be determined with reasonable accuracy and
3) economic performance with respect to the liability has occurred.

[16] *See* I.R.C. § 162(a) (allowing a deduction for ordinary and necessary expenses of the taxpayer's trade or business).

[17] *See* Treas. Reg. § 1.461-1(a)(2) (1960). The taxpayer may then take the deduction if the all events test requirements are satisfied.

[18] Kristie N. Tierney, Jay A. Soled, J.D., LL.M., and Leonard Goodman, CPA, Ph.D., *Analyzing the new personal casualty loss tax rule*, J. OF ACCOUNTANCY (July 1, 2018), https://www.journalofaccountancy.com/issues/2018/jul/irs-personal-casualty-loss-tax-rules.html.

declaration making all 50 states, four territories and the District of Colombia eligible for federal assistance including the ability of taxpayers to take casualty loss deductions.[19] Casualty losses resulting from hurricanes, tornadoes and earthquakes are well established.[20] It remains to be seen exactly how casualty losses for a virus pandemic will be calculated. The IRS and Treasury will likely provide some guidance and taxpayers and tax professionals will undoubtedly try to aggressively push what they can into the loss calculation.

Taxpayers have the remaining months in 2020 to engage in tax planning that will optimize their losses in a manner that could result in a refund of prior years' taxes paid. Likewise, this may be an opportunity for taxpayers that still owe unpaid income taxes from prior years to reduce or eliminate that tax liability.

1. What is a Section 172 Net Operating Loss?

As a result of COVID-19, 2020 will likely result in losses for many businesses and individuals through no fault of their own. This loss is a product of the business's expenses or deductions exceeding the business's income in the taxable year which is also subject to any loss limitations.[21] The losses from the taxpayer's business during the taxable year will have to be reported by filing a Form 1040 and Schedule C for sole proprietorships[22] or Form 1065 and K-1 for partnerships.[23] Corporate losses can be seen when the corporation fills out Form 1120.[24]

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[19] *COVID-19 Disaster Declarations*, FED. EMERGENCY MGMT. AGENCY, https://www.fema.gov/coronavirus/disaster-declarations (March 13, 2020),
[20] I.R.S., Pub. No. 547, Casualties, Disasters, and Thefts, 1, 3 (2020), https://www.irs.gov/pub/irs-pdf/p547.pdf.
[21] I.R.S., *2019 Instructions for Schedule C*, https://www.irs.gov/instructions/i1040sc (last visited June 12, 2020); I.R.S., *Form 1065,* https://www.irs.gov/pub/irs-pdf/f1065.pdf (last visited June 18, 2020).
[22] *See 2019 Instructions for Schedule C.*
[23] *See Form 1065, see also* I.R.S., Partner's Instructions for Schedule K-1, https://www.irs.gov/pub/irs-pdf/i1065sk1.pdf (last visited June 18, 2020).
[24] I.R.S., *Form 1120*, https://www.irs.gov/pub/irs-pdf/f1120.pdf (last visited June 18, 2020).

When a corporation's deductions exceed the income, the corporation will have a Loss Year because the corporation's taxable income will be negative.[25]

When filling out a tax return, an individual or corporation must first determine whether they have taxable income for the year, which section 63 of the Code defines as "gross income minus the deductions allowed."[26] If a taxpayer has taxable income that exceeded the taxpayer's deductions, the taxpayer will not have a NOL. If a taxpayer has "negative taxable income" meaning that the taxpayer's deductions exceeded the taxpayer's adjusted gross income, the taxpayer may have a NOL.[27] Ultimately, a taxpayer's business's loss from operating the business is just one part of the taxpayer's potential NOL.

The Code in section 172 defines NOL as "the excess of the deductions allowed by this chapter over the gross income."[28] One part of the deductions allowed is the taxpayer's share of the business loss.[29] The NOL permits deductions allowed under the Code to be netted against the business income and nonbusiness income. Under section 172 of the Code, if the taxpayer has a NOL, the NOL can be used as a NOL deduction. [30] This NOL deduction can be carried back or carried forward and used to offset taxable income in a carryback or carryforward year.[31]

Typically, a NOL results from losses from a taxpayer's trade or business. The limits on NOL include capital losses in excess of capital gains and nonbusiness deductions in excess of

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[25] *Id.*, *See also* I.R.S., 2019 Instructions for Form 1120, 1, 15, https://www.irs.gov/pub/irs-pdf/i1120.pdf (last visited June 18, 2020).
[26] I.R.C. § 63(a).
[27] I.R.S., Pub. No. 536 Net Operating Losses (NOLs) for Individuals, Trusts, and Estates, 1, 2, 4 (2020), https://www.irs.gov/pub/irs-pdf/p536.pdf.
[28] I.R.C. § 172(c).
[29] *See* I.R.S., Pub. No. 536 at 2.
[30] I.R.C. § 172(a); Treas. Reg. § 1.172-1(a) (as amended in 1986) (allowing a NOL deduction to offset a taxpayer's taxable income in the carryback or carryforward year).
[31] *Id.*

nonbusiness income, among other items.[32] In calculating a NOL, an individual taxpayer needs to engage in more a detailed analysis by distinguishing business deductions from nonbusiness deductions as well business income from nonbusiness income, as illustrated below:

> a) Nonbusiness deductions include 1) alimony paid, 2) deductions for contributions to an individual retirement account (IRA) or a self-employed retirement plan, 3) health savings account deduction, 4) archer medical savings account deduction, 5) most itemized deductions (except for casualty and theft losses resulting from a federally declared disaster and state income tax on trade or business income), and 6) the standard deduction.[33]
>
> b) Business deductions include but are not limited to 1) losses relating to the trade or business or an individual's partnership or S corp. share of the losses, 2) business using the accrual accounting method with losses on the sale of accounts receivable. 3) state income tax on income from your trade or business (including wages, salary, and unemployment compensation) 4) rental losses and 5) loss on the sale or exchange of business real estate or depreciable property…[34]
>
> c) Business income includes 1) salaries and wages 2) self-employment income 3) unemployment compensation 4) rental income 5) ordinary gain from the sale or other disposition of business real estate or depreciable business property 6) your share of business income from a partnership or an S corporation.[35]
>
> d) Nonbusiness income includes 1) taxable IRA distributions 2) pension benefits 3) social security benefits. 4) annuity income 5) dividends 6) interest on investments 7) share of nonbusiness income from a partnership or an S corporation.[36]

All of these items play significant roles when determining the amount of a NOL and the taxable income of the taxpayer. It is critical to remember that when looking at the lists above, if

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[32] *See* I.R.S., Pub. No. 536. at 2.

1. Capital losses in excess of capital gains.
2. The section 1202 exclusion of the gain from the sale or exchange of qualified small business stock.
3. Nonbusiness deductions in excess of non- business income.
4. The NOL deduction.
5. The section 199A deduction for qualified business income.
6. The section 199 deduction for income attributable to domestic production activities.

[33] *Id.* at 4.
[34] *Id.*
[35] *Id.*
[36] *Id.*

the taxpayer's allowed deductions exceed the taxpayer's adjusted gross income the taxpayer may have a negative taxable income that could result in a NOL.[37]

2. Who Can Utilize a NOL?

The Code defines a person as an "individual, a trust, estate, partnership, association, company or corporation."[38] The Internal Revenue Service ("IRS") breaks down who can use a NOL into two separate groups of taxpayers: 1) individuals, trusts, and estates, and 2) corporations. The treatment and calculation of a NOL is based on the type of taxpayer, but both types of NOLs typically start at the same point with a net negative taxable income. After which, different things come into play when calculating the taxpayer's NOL. In looking at a corporation, it is important to note the distinguishing characteristics from individuals. Additionally, another important distinction must be made within the corporation by differentiating a "C" corporation from a "S" corporation.

a. Corporations

Corporation have significant distinguishing characteristics from individuals. Corporations at their root are separate and distinct legal entities from their shareholders.[39] Corporations possesses rights and responsibilities similar to individuals.[40] Corporations are also limited liability entities where the shareholders do not have personal liability, but the shareholders are entitled to receive profits.[41]

Not all corporations are subject to taxes at the corporate level. When looking at corporations another distinction must be made by the taxpayer, and this distinction is whether the

[37] *Id.* at 2.
[38] I.R.C. §7701(a)(1).
[39] *Corporation*, Black's Law Dictionary (11th ed. 2019).
[40] I.R.S., *Forming a Corporation*, https://www.irs.gov/businesses/small-businesses-self-employed/forming-a-corporation (last visited June 14, 2020).
[41] *Id.*

corporation is a C corporation ("C Corp." or "C. Corps" in the plural) or a S corporation ("S Corp." or "S. Corps" in the plural). This difference has drastic implications for tax purposes. The United States taxes C Corps. through the corporate entity itself instead of taxing the individual shareholders.[42] The shareholders however do not escape tax liability altogether on the profit from the corporation, because when shareholders receive the profit in the form of dividends they are subject to tax on those dividends.[43] The U.S. essentially taxes a corporation's earnings twice but at different levels.

Conversely, a S Corp. is generally not subject to income tax at the corporate level. Instead, the income, losses, deductions, and credits are passed through to the shareholders.[44] This passthrough entity operates similarly to a partnership for tax purposes. The NOL from a S Corp. would be subject to certain limitations and passes through to be analyzed as part of the individual taxpayer's overall income.[45] Not every corporation can elect to be a S Corp. since it requires the satisfaction of certain requirements outlined by the IRS.[46] All the shareholders must sign the Form 2553 to elect, otherwise the election cannot be made.[47]

The advantages of a S Corp. are that an election will prevent the double taxation seen with a C Corp. analysis. However, all the requirements must be met. Additionally, all the

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[42] *Id.*
[43] *Id.*
[44] *S Corporation*, https://www.irs.gov/businesses/small-businesses-self-employed/s-corporations (last visited May 28, 2020).
[45] *Id.*
[46] *Id.* The requirements of an S Corporation are:

1. Be a domestic corporation
2. Have only allowable shareholders
    a. May be individuals, certain trusts, and estates and
    b. May not be partnerships, corporations or non-resident alien shareholders
3. Have no more than 100 shareholders
4. Have only one class of stock
5. Not be an ineligible corporation (i.e. certain financial institutions, insurance companies, and domestic international sales corporations).

[47] *Id.*

shareholders must agree to elect for the corporation to be a S Corp. in order for the election to be made. For some corporations, an election may not be possible because of failing to meet some of the election requirements or not all shareholders agreeing to the election due to their own tax situations.[48]

b. Individuals, Trust and Estates

Under the Code, taxes are imposed on individuals, which includes single people and married couples.[49] A trust is a legal arrangement involving a fiduciary relationship between a person ("beneficiary") and the person in charge of the trust, ("trustee").[50] The trustee is obligated to hold or use the property in a manner that benefits the recipient beneficiary.[51] An estate is the collection of the possessions a person leaves behind upon their death to be distributed to beneficiaries and heirs.[52] Trusts and estates deal with NOLs in a similar manner as individuals except for the different forms that must be filed with the IRS.[53] A partnership or S Corp. cannot recognize a NOL because they act as pass through entities whereas the individuals who hold an ownership interest in the partnership or shares in a S Corp. can recognize with certain limitations their share of the NOL.[54]

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[48] I.R.S., *Instructions for Form 2553*,1, 1, https://www.irs.gov/pub/irs-pdf/i2553.pdf (last visited June 14, 2020) (stating that S Corp.'s cannot elect if it has nonresident alien shareholders).
[49] I.R.C. § 1(a)(1), § 1(c), § 1(d).
[50] *Trust*, Black's Law Dictionary (11th ed. 2019).
[51] *Id.*
[52] *Estate*, Black's Law Dictionary (11th ed. 2019).
[53] *See* I.R.S., Pub. No. 536 at 5.
[54] I.R.S., Pub. No. 925 Passive Activity and At-Risk Rules, 1, 2, 12 (2020), https://www.irs.gov/pub/irs-pdf/p925.pdf.

3. Using the NOL

a. Carryback and Carryforward

When using a NOL, a taxpayer historically had the option to carryback or carryforward a NOL. Various tax reforms have impacted NOLs over the years so the laws on using a NOL change over time.[55] Before the 2017 Act, taxpayers enjoyed a two-year carryback period and a 20-year carryforward period. The 2017 Act did away with carrybacks and made the carryforward periods indefinite.[56] The 2017 Act also imposed a cap on the carryforward NOL at 80% of the taxpayer's taxable income for any year that the carryover is being applied.[57] The CARES Act reversed course on these two major points with NOLs. First, the CARES Act brought back the NOL carryback. This newest version of the carryback allows for NOLs to be carried back for five years.[58] This means 2018 NOLs, which before the CARES Act could not be carried back, can now be carried back to 2013.

Additionally, the CARES Act removed the 80% taxable income cap on carryforwards until 2021.[59] For most taxpayers, this is welcome news especially given the crisis that has unfolded due to COVID-19 and the likely loss of income that many businesses and individual taxpayers will experience. The carryback option is subject to an irrevocable election by the taxpayer, which waives the ability to use the NOL during the whole carryback period.[60] The taxpayer cannot pick and choose what years to apply a NOL. If a taxpayer opts to use a NOL carryback, the NOL is offset against the earliest year allowed in the period (e.g. 2013 would the first offset year for a

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[55] *See* Owsley, *supra* note 3.
[56] 2017 TCJA § 13302(a).
[57] *Id.*
[58] CARES Act § 2303(b).
[59] *Id.* at §2303(a).
[60] I.R.C. § 172(b)(3).

2018 NOL). Any excess NOL not used in that specific year goes toward the next year in the period and this procedure continues until the NOL is eventually used up or the period runs out.

The resurrection of the carryback provides significant relief for many individuals and corporations. While a carryforward can offset future tax liability, the carryback offers a chance at a refund on taxes already paid. The NOL carryback reduces taxable income for the carryback year allowed under the provision and calculates a new tax liability with the NOL. The refund comes from the difference originally paid in that carryback year and the new calculated liability.

The applicable NOL refund provides taxpayers access to liquidity in these times of economic distress. For many taxpayers, the bills did not stop when business revenues stopped. As many individuals and corporations struggle to meet their existing financial obligations, the need for cash has never been greater. The increased liquidity from a carryback gives many businesses and individuals a fighting chance to stay financially afloat.

Although carrybacks will likely result in an immediate loss of revenue for the U.S. Federal Government due to the refunds that will be paid out, this revenue loss will be offset over time. The decrease in NOL carryforwards as a result of the use of NOL carrybacks will offset the revenue loss in some regards with fewer 2018, 2019, and 2020 NOLs carryforwards. Ultimately, carryforwards could take years for taxpayers to recognize. The time needed for carryforwards prompts the question of whether the business will survive long enough to utilize the carryforward. The government recognized this issue and sought to address it by bringing back the NOL carryback in the CARES Act. The carryback offers many distressed taxpayers an immediate lifeline that a carryforward cannot offer.

b. Maximizing the NOL

The formula for calculating a NOL is (total deductions – disallowed deductions) – total income = NOL. When trying to maximize a NOL, the taxpayer should note that enhancement comes from the losses and deductions relating to the taxpayer's trade or business. Nonbusiness deductions do not enhance, nor do they reduce a NOL. The part of the equation that can end up reducing a possible NOL would be the income related to the trade or business. A taxpayer's trade or business directly affects the possible NOL and as such, in a NOL year a taxpayer should seek to limit his trade or business income. For example, if a taxpayer's goal is to maximize his NOL year, the taxpayer should hold off any sales of business, real estate or depreciable business property that could result in a gain. If businesses have outstanding lawsuits, a settlement before the end of 2020 will allow the taxpayer to utilize a business deduction if there is a sufficient business connection to the lawsuit.[61] Thus, this settlement would increase the NOL in a loss year.

The NOL is not enhanced by the nonbusiness deductions as mentioned above. The nonbusiness deductions are accounted for by adjusting the total deductions from items not allowed in Form 1045.[62] In terms of efficiency, a taxpayer should seek to utilize this deduction by increasing the taxpayer's nonbusiness income to match to the taxpayer's nonbusiness deduction in a loss year as closely as possible. A large nonbusiness deduction does not affect the NOL and if the nonbusiness deduction if not matched by nonbusiness income, a missed opportunity results for the taxpayer if the taxpayer has any nonbusiness deduction amount

[61] *See* Treas. Reg. § 1.461-1(a)(2) (1960). The taxpayer must satisfy the all events test to take a deduction.

1) All events have occurred giving rise to the liability have occurred,
2) liability amount can be determined with reasonable accuracy and
3) economic performance with respect to the liability has occurred;

See also I.R.C. § 162(a) (allowing a deduction for ordinary and necessary expenses of the taxpayer's trade or business).

[62] I.R.S., *Instructions for Form 1045*, 1, 2, https://www.irs.gov/pub/irs-pdf/i1045.pdf (last visited June 10, 2020).

leftover. Ultimately, the NOL deduction is recognized under section 172 but is subject to any loss limitations and tests under the Code.

c. Limitations

Business losses are subject to the limitations prescribed by the IRS. Individuals who are partners in a partnership or shareholders of an S Corp. must be aware of the tax basis limitation before applying the at-risk and passive loss limitations to business losses. [63] When dealing with business losses, some of the biggest limitations taxpayers may face include the At-risk[64] and Passive Activity Loss Limitations.[65] For individuals, the limitations also include the excess business loss limitation.[66] While for corporate businesses, the limitations include the section 382 limitation on business ownership change.[67] Additionally, other tests and limitations include but are not limited to the constructive receipts doctrine[68], substance over form doctrine[69], the claim of right doctrine[70], the all events test[71], corn products doctrine[72], and the ordinary and necessary

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[63] I.R.C. § 704(d) (discussing basis limitation for partners in a partnership), I.R.C. § 1366(d) (detailing basis limitations for S Corp. shareholders).
[64] *See* I.R.S., Pub. 925 at 12.
[65] *Id.* at 2.
[66] I.R.C. § 461(l).
[67] I.R.C. § 382(a).
[68] Treas. Reg. § 1.451-2(a) (as amended in 1979). The regulations treat income not yet in possession of the taxpayer as constructively received and subject to tax in that year if the taxpayer has control of the income, which typically occurs when his account is credited, or the income is made available to the taxpayer.
[69] *See* Gregory v. Helvering, 293 U.S. 465, 469-70 (1935). A transaction's substance, not the form decides the federal tax consequences. Things to look when determining substance are whether the transaction was devoid of economic substance or no nontax business purpose.
[70] I.R.C. § 1341. This section applies when there is a dispute of the amount, but the taxpayer receives payment. *See also* N. Am. Oil Consol. v. Burnet, 286 U.S. 417, 422-24 (1932). (stating if a taxpayer receives earnings under claim of right and without restrictions as to its disposition, he has received income even if he may later be required to return even though there may still be a claim that he is not entitled to retain the money and even though he may still be adjudged liable to restore its equivalent).
[71] I.R.C. § 461(h)(4)(stating that all-events test is satisfied when "all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy"), *See also* § 1.461-1(a)(2).For deductions under the all events test, it must pass a three prong test. The three prongs are: 1.) All events giving rise to the liability occurred, 2.) the amount can be determined with reasonable accuracy, and 3.) economic performance relating to the liability has happened.
[72] Corn Prods. Ref. Co. v. Comm'r, 350 U.S. 46, 52 (1955) (holding that inventory used in the daily business operations are excluded under the narrow interpretation of a capital asset and therefore subject to treatment as ordinary income or loss).

test.[73] The list is extensive and could be discussed at great lengths on every possible limitation. However, for this article, the focus will be narrowed to the Basis, At-risk, Passive Activity, Excess Business Loss, and section 382 limitation relating to ownership change.

1. Basis

For many taxpayers, the first limitation that must be applied to a business loss is the tax basis limitation. The taxpayers that need to pay close attention to this limitation are typically shareholders in a S. Corp., partners in partnership. The tax basis is ordinarily the taxpayer's cost for the property subject to any adjustments.[74] In terms of a partnership, it will likely be the partner's cost in forming the partnership in addition to any adjustments to basis taken by the partner. For a S Corp., it will likely be the taxpayer's cost of the shares subject to any adjustments. A taxpayer's losses are limited to the taxpayer's basis. This means a partner's share of the partnership loss is limited to the partner's adjusted basis in the Loss Year.[75] A shareholder's losses from a S. Corp. are limited to the adjusted basis of the stock and the S. Corp.'s indebtedness to the shareholder.[76] After applying the tax basis limitation to the losses, the taxpayer must then apply the other loss limitations prescribed by the Code.

2. At-risk

Following the application the tax basis limitation, a taxpayer would then apply the at-risk limitation to the loss. Under section 465 business losses are limited to the amounts at-risk and this limitation applies to both individuals and C Corps who have met the stock ownership

[73] *See I*.R.C. § 162, *See also* Indopco, Inc. v. Comm'r, 503 U.S. 79, 85-86 (1992) (stating that ordinary mean "of common or frequent occurrence in the type of business involved."), *See also* Welch v. Helvering, 290 U.S. 111, 113 (1933) (finding that necessary means "appropriate and helpful" while relying on the taxpayers business judgment).
[74] *See* I.R.C. § 1012 (cost basis), I.R.C. § 1016 (adjusted basis).
[75] I.R.C. 704(d).
[76] I.R.C. § 1366(d).

requirement.[77] This Code section seeks to limit the taxpayer's business loss for the taxable year to the amount that is at-risk. The at-risk amount can be a combination of "the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity and amounts borrowed with respect to such activity."[78] Borrowed amounts require that the taxpayer be personally liable for the debt through a recourse loan.[79] In contrast, a nonrecourse loan can become at-risk when the loan has been guaranteed with a different property as a security for the debt.[80] Essentially, what the Code indicates is that for a debt or loan to be considered at-risk for the taxpaying individual, it almost always needs to be a recourse loan.[81]

The at-risk limitation only applies to certain types of activities. Although the Code lists these certain activities, the limitation also extends to any trade or business activities for the production of income that was not listed in the Code section for which the taxpayer is at-risk.[82] This Code section was designed to prevent tax avoidance by persons being able to take on large losses and deduct those losses against their income, when in reality the taxpayer was never really on the hook for the large amounts.[83] The taxpayer is limited to the risk that taxpayer is

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[77] I.R.C. § 465(a)(1)(A-B).
[78] I.R.C. § 465(b)(1)(A-B).
[79] *Id.*
[80] *Id.*
[81] *See* I.R.S., Pub. No. 925 at 14-15. At-risk loans must typically be recourse except for certain qualified nonrecourse loans that are:

1. Borrowed by you in connection with the activity of holding real property,
2. Secured by real property used in the activity,
3. Not convertible from a debt obligation to an ownership interest, and
4. Loaned or guaranteed by any federal, state, or local government, or borrowed by you from a qualified person.

[82] I.R.C. § 465(c)(3)(A)(i).
[83] Boris I. Bittker, Martin J. McMahon, & Lawrence A. Zelenak, *A Whirlwind Tour of the Internal Revenue Code's At-Risk and Passive Activity Loss Rules*, 36 REAL PROP. PROB. & TR. J. 673, 683-84 (2002), available at http://scholarship.law.ufl.edu/facultypub/580

responsible for in terms of the loan and for the amount of money the taxpayer has put into the property or project.

3. Passive Activity

The passive activity loss limitation applies after the at-risk limitation has been applied to the losses. Passive activities are certain types of business or investment activities in which a taxpayer did not materially participate in during the tax year.[84] There are two types of passive activities that are subject to the limitation on the deduction of the losses under section 469.[85] These activities occur when a taxpayer did not actively contribute to the trade or business, or certain rental activities for which the generation of income is attributable to the property and not to the labor or other efforts of the taxpayer.[86] This limitation applies to the following taxpayers: individuals, estates or trusts, closely held C Corps, and personal service corporations.[87] The Code defines passive activity loss as "the amount by which the aggregate losses from all passive activities for the taxable year exceeds the aggregate income from all passive activities for such year."[88] A passive activity is any activity, which involves a trade or business in which the taxpayer does not materially participate.[89] To break it down further, we must look at what activities are subject to passive activity rules, what constitutes a trade or business and what is material participation. For guidance on what activities qualify as passive, we must turn to the Treasury Regulations.

[84] I.R.C. § 469(c).
[85] *See* I.R.S., Pub. No. 925 at 3.
[86] *Id.*
[87] I.R.C. § 469(a)(2).
[88] I.R.C. § 469(d)(1)(A-B).
[89] I.R.C. § 469(c).

The Treasury Regulations define activity as "[o]ne or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469."[90] The Regulations also state that "whether activities constitute an appropriate economic unit and, therefore, may be treated as a single activity depends upon all the relevant facts and circumstances."[91] The factors under this test include: "similarities and differences in types of trades or businesses, the extent of control, the extent of common ownership, and geographical location" to name a few. Material participation by a taxpayer is defined as "regular, continuous and substantial."[92] Material participation is an objective test that can be satisfied in various ways by the taxpayer if the taxpayer satisfies one of the seven tests outlined in the Regulations.[93] Some exceptions exist for activities that would typically constitute passive activity. These exceptions apply to portfolio income and rental activities with material participation by the taxpayer with losses of up to $25,000.[94]

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[90] Treas. Reg. § 1.469-4(c)(1) (as amended in 1995).
[91] Treas. Reg. § 1.469-4(c)(2) (as amended in 1995).
[92] I.R.C. §469(h).
[93] Temp. Treas. Reg. § 1.469-5T(a) (1-7) (as amended in 1996). The tests include:

1) The individual participates in the activity for more than 500 hours during such year;
2) The individual's participation in the activity for the taxable 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;
3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable 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;
4) The activity is a significant participation activity for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;
5) The individual materially participated in the activity for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;
6) The activity is a personal service activity, and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or
7) Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during such year.

[94] I.R.C. § 469(e)(1); I.R.C. § 469(i); I.R.C. § 469(c)(7).

The main takeaway from passive activity loss limitation is that in a particular year if a taxpayer has passive losses that exceed passive gains, then the taxpayer will have a passive loss that cannot be deducted against nonpassive income. That passive loss, with some exceptions, is not deductible in the current year. A passive loss can be carried forward and deducted against future passive income.[95] The types of taxpayers that need to be cognizant of this limitation are likely limited partners and real estate investors who do not qualify as real estate professionals.[96] These limited partners or types of real estate investors would not be able to deduct business losses that arise because they would likely fall victim to the passive loss limitation. This limitation intends to prevent taxpayers from utilizing passive losses against their nonpassive income, thereby preventing manipulation from taxpayers who would attempt to create negative tax liabilities or significantly reduce their tax liability on nonpassive income. Concerning NOL, passive activity loss is not included in the NOL calculation. Since a passive loss cannot be carried back, the passive loss will not help a taxpayer looking to take advantage of the CARES Act NOL Carryback resurrection.

4. Excess Business Loss

The 2017 Act made way for the advent of a new limitation called the excess business loss limitation. The excess business loss limitation applies after the basis, at risk and passive activity limitations. One author stated that the excess business loss limitation "violates the most basic

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[95] Treas. Reg. § 1.469-1(f)(4) (as amended in 2002).

[96] I.R.C § 469(c)(7)(B)(i-ii). A taxpayer must satisfy these two requirements to qualify as a real estate professional.

> (1) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
>
> (2) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

notions of what an income tax is."[97] The limitation penalizes individuals involved in startup businesses and other businesses that have a large amount of business losses by unfairly "creating a tax base that includes more than net income."[98] So, it is only fitting that the temporary revival of the NOL carryback saw the postponement of the excess business loss deduction as part of the CARES Act.[99] The excess business loss limitation applies to noncorporate taxpayers which means individuals, trusts, and estates were subject to the limitation.[100] Excess business loss is the excess of the taxpayer's total trade or business deductions minus the sum of the total trade or business income or gain plus $250,000 for a single taxpayer or $500,000 for joint filers.[101] The excess amount is treated a NOL carryover that the taxpayer may use in the future.[102]

The CARES Act repealed the excess business limitation until 2021.[103] Taxpayers that have been limited by this limitation will need to go back and amend 2018 and 2019 in order to fully utilize the deduction as those years are no longer subject to the limitation.[104] This change will allow taxpayers who had to pay income tax because of the limitation to obtain refunds in 2018 or 2019 and will further help taxpayers who had a NOL in 2018 or 2019 that were limited by the excess business loss limitation and only allowed to carry forward both NOLs. Now, taxpayers will be able to go back use the full amount of their loss as carryback instead of a carryforward. For taxpayers, this is a welcome reversal from 2017 Act even if temporary. The taxpayers will now able to collect refunds on taxes paid if they were subject to the excess

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[97] Steven Z. Hodasyz, *The Curious Case of Section 461(l): Why This Unclear and Unwise New Rule Should Be Construed as Narrowly as Possible*, THE TAX LAWYER, Vol. 73, No. 1, 61, 159 (2019).
[98] *Id.*
[99] CARES Act §2304(a)(1)(B).
[100] I.R.C. § 461(l)(1).
[101] I.R.C. § 461(l)(3)(A)(i-ii).
[102] I.R.C. § 461(l)(2).
[103] CARES Act §2304(a)(1)(B).
[104] CARES Act §2304(a) (amending § 461(l)(1) that originally stated excess business loss would apply beginning in 2018).

business loss in 2018 or 2019. The other option for taxpayers would be larger NOLs to carryback to previous years. The temporary repeal of the excess business loss limitation is a win for taxpayers who need access to liquidity now.

5. Section 382 Limitation on Carryforwards Following Ownership Change

Corporate businesses may be facing potential changes to ownership and structure due to COVID-19. Some corporations may have shareholders looking to sell or otherwise dispose of their interest as a result of the economic downturn. In contrast, other shareholders may see this downturn as an opportunity to increase their ownership shares. When dealing with a corporation's potential NOL, an analysis must begin to determine whether there was a change in ownership that could trigger section 382. This Code section comes into play when within a three year period there is an aggregate change of ownership that is equal to an excess of 50%.[105] This section once triggered places a limitation on the use of the corporation's NOL carryforward.[106] The limitation of section 382 equals the value of the old loss corporation times the long-term tax-exempt rate.[107] Any company that has undergone or contemplating an ownership change should

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[105] I.R.C. § 382(g)(1)(A-B).

(g) **Ownership change** For purposes of this section—

(1) **In general** There is an ownership change if, immediately after any owner shift involving a 5-percent shareholder or any equity structure shift—

(A) the percentage of the stock of the loss corporation owned by 1 or more 5-percent shareholders has increased by more than 50 percentage points, over

(B) the lowest percentage of stock of the loss corporation (or any predecessor corporation) owned by such shareholders at any time during the testing period.

[106] I.R.C. § 382(a).

[107] I.R.C. § 382(b)(1)(A-B);

See also I.R.C. § 382(e)(1) (defining value of old loss corporation)

(e) **Value of old loss corporation** For purposes of this section—

(1) **In general**

Except as otherwise provided in this subsection, the value of the old loss corporation is the value of the stock of such corporation (including any stock described in section 1504(a)(4)) immediately before the ownership change;

See also I.R.C. § 382(f)(1)

(f) **Long-term tax-exempt rate** For purposes of this section—

(1) **In general**

be cognizant of potential section 382 limitations as they relate to NOL carryforward. Shareholders interested in increasing their ownership share should be also considering the effect of a section 382 limitation especially if there are NOLs in play. Corporations subject to an ownership change should note that as section 382 indicates, this limitation applies only to carryforwards, which means carrybacks are not subject to section 382 limitation as defined under the Code.[108] A corporation that faces a section 382 limitation on its' ability to utilize the NOL carryforward will welcome the opportunity to carryback the NOL to avoid this limitation.

4. Tax Planning and Strategy

a. The Process

When looking at a taxpayer's potential NOL after taking the limitations into account, the taxpayer should first review the prior five to seven years of tax returns eligible for the NOL carryback. The taxpayer should only utilize the NOL carryback if there is a viable opportunity to obtain a refund. If the taxpayer does not determine that a refund is large enough to be worthwhile, the taxpayer should likely waive the carryback period and elect to carryforward the NOL.[109] The taxpayer should then begin the process by filling out a tax return for 2019 if not already done so to see if there is a potential NOL carryback to be had. The taxpayer should proceed to file the tax return if the taxpayer estimates that he could have a NOL. If returns have not been filed for 2019, a taxpayer should file as soon as possible to receive a NOL refund from taxes paid in the years 2014 to 2018. With the 2018 and 2019 tax years closed, a taxpayer that

The long-term tax-exempt rate shall be the highest of the adjusted Federal long-term rates in effect for any month in the 3-calendar-month period ending with the calendar month in which the change date occurs.

[108] I.R.C. § 382 (b)(2) (illustrating that the excess of the § 382 limitation and the loss after the ownership change corporation's taxable income should be carried forward to the next year).

[109] I.R.C. § 172(b)(3).

has already filed for 2018 and 2019 should explore amending his or her returns or filing one of the applicable forms the IRS allows to receive the refund.

Unlike 2018 and 2019, the 2020 taxable year presents some planning opportunities with the remaining months. A taxpayer should project the potential NOL based on running current business operations versus some tax planning strategies to potentially enhance a NOL. These strategies include but are not limited to accelerating business deductions and losses, settling lawsuits or utilizing strategies within the taxpayer's accounting methods.[110] For many potential 2020 NOLs, the tax returns cannot be filed until the beginning of 2021 at the earliest, so the time to act is now.

The opportunity to enhance a NOL as opposed to operating the business normally can present itself in various ways. For instance, a business with pending lawsuits in a year that is shaping up to be a Loss Year should see the potential to settle these lawsuits to claim a business deduction. This settlement would close the legal matter and allow the business to take a deduction on the matter as a business expense, which would potentially increase the business's NOL.[111] Another example of effective tax planning would be to make sure taxpayers with excess inventory sell at a loss before the year-end. This sale at a loss would enhance the taxpayer's NOL in 2020. These suggestions are just a few brief points to illustrate potential tax strategies to maximize the NOL.

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[110] *See* Treas. Reg. § 1.166-1(a) (as amended in 1986) (displaying that a bad debt deduction may be allowed for debts owed to a taxpayer that became worthless or partially during the taxable year). *See also* Treas. Reg. §1.166-1(e) (as amended in 1986) (requiring that the worthless debt be already included in income for the taxpayer's taxable year). This would likely mean that this deduction would be allowed for an accrual method taxpayer because of the inclusion of income when it is earned, while a cash basis taxpayer likely cannot utilize this deduction because the income is recognized when received.

[111] *See* I.R.C. § 451(b)(1)(C). (discussing the all events test for gross income inclusion).

1) If all the events have occurred which fix the right to receive such income and
2) the amount of such income can be determined with reasonable accuracy.

See also § 165 (describing deductions allowed for business losses).

Additional planning and strategies could include ways to avoid the at-risk and passive activity loss limitations. For example, if a taxpayer is not at-risk for a loan it could limit the taxpayer's NOL. To prevent the NOL from being reduced, the taxpayer should make sure the loans attributable to the taxpayer's trade or business are recourse loans or meet the certain requirements for qualified nonrecourse loans.[112] Additionally, the taxpayer in an effort to prevent the NOL reduction can also increase the basis the taxpayer has in the property by contributing more money.[113] The taxpayer should be cognizant that being personally liable for the loan or increasing the basis through money contributions will allow the taxpayer to avoid the at-risk limitation and help maximize the taxpayer's NOL in a Loss Year.

Another potential strategy would be for a taxpayer who may be subject to the passive loss limitation. To avoid the passive activity loss limitation, a taxpayer must materially participate in the activity. The taxpayer or the taxpayer's spouse would only need to satisfy one of the seven tests that can satisfy the material participation requirement.[114] Therefore, any taxpayer that could be subject to passive loss limitation should find a way to materially participate in these remaining months of 2020. For example, the taxpayer could dedicate 500 hours between now and the end of the year to satisfy the requirement.[115] Additionally, a taxpayer could avoid the limitation if the taxpayer disposes of the entire interest in the passive activity.[116] The taxpayer is

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[112] *See* I.R.S., Pub. No. 925 at 14-15. At-risk loans must typically be recourse except for certain qualified nonrecourse loans that are:

1. Borrowed by you in connection with the activity of holding real property,
2. Secured by real property used in the activity,
3. Not convertible from a debt obligation to an ownership interest, and
4. Loaned or guaranteed by any federal, state, or local government, or borrowed by you from a qualified person.

[113] *Id.* at 14.

[114] *Id.* at 5.

[115] Temp. Treas. Reg. § 1.469-5T(a)(1) (as amended in 1996).

[116] *See* I.R.C. § 469(g).

allowed to deduct the passive activity losses in the year the taxpayers disposes of the interest in the passive activity.[117] This deduction allows the passive losses previously not allowed to be used against passive income from that activity in the disposition year.[118] If a passive loss remains, this loss is offset against passive income from all other passive activities.[119] Finally, if after offsetting the passive income from other activities, any remaining passive loss is offset against other income in the disposition year.[120] These actions would allow the taxpayer to avoid the passive loss limitation to the NOL, thus allowing for the taxpayer to maximize the NOL carryback or carryforward.

Additionally, a taxpayer who engages in home rentals may be able to avoid the passive activity loss limitation through the rental activity exception.[121] Rental activity is typically considered passive activity. However, if the property was used by customers for average use of seven days or less then it may qualify for the rental activity exception.[122] Some taxpayers who rent their homes or properties may be able to convert the rentals into short-term rentals to meet this exception. Taxpayers who rent their property on sites such as Airbnb[123] and VRBO[124] are the kinds of taxpayers who may qualify for this exception. The taxpayer who meets the use requirement for the exception would then also need to meet the active participation requirement. The active participation element requires a taxpayer to make management decisions such as who

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[117] I.R.C. § 469(g). The requirements of the disposition of an entire interest include:

1. The taxpayer disposes of his entire interest in any passive activity or former passive activity
2. If all gain or loss realized is recognized upon such disposition
3. Not from a related party
4. The excess of any loss from such activity over any net income or gain for such taxable year then the excess shall be treated as a loss which is not from a passive activity and will be treated as § 165 loss.

[118] I.R.C. 469(g)(1)(A).
[119] I.R.C. 469(g)(1)(A).
[120] I.R.C. 469(g)(1)(A).
[121] I.R.S., Pub. 925 at 3.
[122] *Id.*
[123] AIRBNB, https://www.airbnb.com (last visited June 22, 2020).
[124] VRBO, https://www.vrbo.com (last visited June 22, 2020).

can stay on the property.[125] Sites like Airbnb offer the property hosts the ability to accept or decline rental offers.[126] This decision making likely would help the taxpayer meet the active participation requirement. A taxpayer with effective planning on the use and active participation requirements and possible conversion to short term rentals can likely avoid the passive activity loss limitation and recognize these rental losses helping enhance the taxpayer's NOL.

b. Strategic Planning Based on Tax Rates

Additionally, unlike individual taxpayers who are subject to a progressive tax based on the income tax brackets, corporations since the passage of the 2017 Act are subject to a 21% flat tax.[127] Corporations seeking to maximize a NOL should recognize a great opportunity to carryback NOLs into years where the corporate tax rate was higher than it is now. Before 2017 Act, the IRS taxed corporations at a top tax rate of 35%.[128] The 2017 Act paved the way for a lower tax rate as it implemented a 21% tax rate.[129] Corporations now have a golden opportunity to carryback an NOL from 2018 to 2020 back five years. For corporations with a 2018 NOL, this means utilizing the NOL to five years that were taxed at 35%. For a 2020 NOL, the NOL would be use against three years that were taxed at 35%. The NOL would be most efficiently maximized by carrying it back into those higher-taxed years instead of a carryforward on years taxed at 21%. The carryback provides money and liquidity to the taxpayer as soon the year ends. The amount of taxes paid in 35% taxed years is likely greater so in most cases the access to liquidity and greater utilization makes the carryback a great option for corporations.

[125] I.R.S., Pub. 925 at 4.
[126] *What do I do after I Get a Request to Book*, AIRBNB, https://www.airbnb.com/help/article/28/what-do-i-do-after-i-get-a-request-to-book (last visited June 14, 2020).
[127] *How did the Tax Cuts and Jobs Act change business taxes?*, TAX POLICY CTR., https://www.taxpolicycenter.org/briefing-book/how-did-tax-cuts-and-jobs-act-change-business-taxes (last visited June 4, 2020).
[128] *Id.*
[129] *Id.*

When considering whether to ultimately carryback or carryforward, a taxpayer should be cognizant of the effects a carryback may have on Alternative Minimum Tax years, section 965 years, and other tax provisions such as the Foreign Tax Credit or the Global Intangible Low-Taxed Income and the affect it could have on those taxable years. Adverse effects on these tax-related issues may make the decision to carryforward a better option for certain taxpayers. Additionally, a taxpayer who took an aggressive or questionable tax position in previous years where the statute of limitations for review has passed may not want to submit those years for a second IRS review. For taxpayers in that position, it might make sense to carryforward. Ultimately, the decision will require weighing the benefit of cash refunds and increased liquidity versus the potential IRS risks of audits and reviews on closed tax years.

c. The Forms

Once the taxpayer has determined there is a NOL, the taxpayer can carryback it or carryforward if the NOL occurs in the years 2018 to 2020. If the taxpayer finds there to be an opportunity for a carryback the next step would be deciding which form to file. Taxpayers have two options when it comes to the forms to be filed. Taxpayers can either file using a "quick refund form" or amend the prior year's tax returns. Both options present some advantages and disadvantages. Individuals can either utilize Form 1040-X which is an amended return or Form 1045 which is known as a "quick refund form" for NOL carrybacks.[130] Trusts and estates that do not file a Form 1045 and must file a Form 1041-X amended return to claim NOL carrybacks.[131] Corporations can either file Form 1120-X amended return or Form 1139 quick return.[132]

[130] I.R.S., Pub. No. 536 at 5.
[131] *Id.*
[132] I.R.S., Pub. No. 542 at 15.

The quick returns present taxpayers with a fast-tracked option for refunds on NOL carrybacks. The IRS processes applications within 90 days after the application is filed.[133] The deadline to file the Form 1045 is typically twelve months from the year-end that NOL was generated.[134] For example, a 2019 NOL Form 1139 or Form 1045 is due by December 31, 2020 for corporations and individuals respectively who follow the calendar tax year, and a 2020 NOL form would be due by December 31, 2021.[135] Additionally, the IRS has allowed taxpayers to fax in the Form 1139 or Form 1145 representing another advantage for the quick refund forms during this pandemic.[136]

For taxpayers not wanting to utilize the quick return form or who missed the deadline for the quick return, the amended returns give the taxpayer more time to file to carryback a NOL. A taxpayer has three years from the due date of the initial return to file the amended return.[137] One drawback is that the taxpayer would have to amend the tax return for every year in the allotted carryback period as the 1040-X only amends the year selected on the form.[138] In contrast, the quick return form applies to all years in the carryback period. The quick return provides efficiency and a faster path to the refund that the amended return option cannot offer. Each taxpayer may have different goals or time constraints so both options should be taken into account depending on the needs of each unique taxpayer.

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[133] *See* I.R.S., *Instructions for Form 1045*, 1, 2, https://www.irs.gov/pub/irs-pdf/i1045.pdf (last visited June 10, 2020). *See also* I.R.S., *Instructions for Form 1139,* 1, 2, https://www.irs.gov/pub/irs-pdf/i1139.pdf (last visited June 10, 2020).
[134] *Id.*
[135] *Id.*
[136] I.R.S., *Temporary procedures to fax certain Forms 1139 and 1045 due to COVID-19,* https://www.irs.gov/newsroom/temporary-procedures-to-fax-certain-forms-1139-and-1045-due-to-covid-19 (last visited July 13, 2020).
[137] I.R.S., *Instructions for Form 1040-X,*1, 5, https://www.irs.gov/pub/irs-pdf/i1040x.pdf (last visited June 9, 2020).
[138] *Id.* at 4.

Conclusion

The CARES Act temporarily allows NOLs to be carried back five years. The tax year 2020 will likely see many businesses suffering significant losses resulting from the economic fallout caused by COVID-19. This article points out that a taxpayer can maximize a NOL by employing some tax planning techniques in combination with the losses likely to exist from COVID-19 to receive quick cash refunds from the IRS.

After coming to that conclusion, an almost limitless discussion could be had of how to engage in a tax planning strategy to enhance the amount of the loss. Rather than creating a treatise on every tax planning technique ever done, this article focusses on how to enhance the NOL in the year 2020 for the purposes of allow a taxpayer to obtain a refund by carrying that NOL back. A non-exhaustive sample to the techniques that will increase losses recognized in 2020 are suggested. Some of the rules, limitations and practical considerations are also discussed.

Hopefully, the reader has gained insight as to the significance of the opportunity the temporary NOL carryback provisions bring and how important it is to act quickly so that the proper planning is in place by December 31, 2020. The reader will also note that this is a complicated task that will touch on numerous provisions of the Tax Code and other sources of U.S. Tax law. In the end, the author hopes that this article will inspire taxpayers and tax professionals to take a deep look to see if there is a refund check waiting to be cashed.

CARES Act Guidance for Coronavirus-Related Distributions and Loans

By Felicia A. Finston, William M. Fisher, and Linda A. Wilkins
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June 30, 2020

The Internal Revenue Service ("**IRS**") has issued Notice 2020-50 providing additional guidance related to coronavirus-related distributions ("**CRDs**") and loans under the Coronavirus Aid, Relief, and Economic Security Act (the "**CARES Act**"). See https://www.irs.gov/pub/irs-drop/n-20-50.pdf. The Notice supplements prior IRS guidance issued under the CARES Act, described in our prior client alerts on enactment of the CARES Act and IRS CARES Act Questions and Answers, available at http://www.wifilawgroup.com/clientalertmar302020.html and http://www.wifilawgroup.com/clientalertmay52020.html.

Expansion of Qualified Individual: The Notice expands the definition of qualified individual ("**QI**") to include:

- A participant whose pay or self-employment income is reduced due to COVID-19 or who has had a job offer rescinded or new job's start date delayed due to COVID-19;
- A participant whose spouse or household member due to COVID-19:
  - is quarantined, furloughed, laid off,
  - has a reduction in work hours, a reduction in pay or self-employed income,
  - is unable to work due to lack of childcare, or
  - has a job offer rescinded or start date for a job delayed, or
- A business owned or operated by the participant's spouse or household member has closed or reduced hours due to COVID-19

A "household member" is someone who shares the participant's principal residence.

Reliance on Employee Certifications. The Notice clarifies that the plan administrator may rely on the participant's certification of QI status so long as it doesn't have reason to know otherwise. There is no duty on the administrator to investigate further. The certification may be relied on for CRDs, CAREs Act loan relief and CRD repayments. The Notice provides a sample certification.

Coronavirus-Related Distribution Clarifications:

- **Designation of a Distribution as a CRD**. A QI may designate any eligible distribution as a CRD by reporting it on his federal income tax return and filing Form 8915-E; provided, that the total amount does not exceed $100,000. For this purpose, periodic payments, distributions that would have been required minimum distributions but for the 2020 CARES Act suspension and loan offset distributions may be designated as a CRD. However, corrective distributions, refunds to comply with the Internal Revenue Code ("**Code**") limits on contributions or nondiscrimination tests and deemed loan distributions may not be designated as CRDs. In addition, a plan may, but is not required to, designate an eligible distribution as a CRD. In determining the $100,000 limit, the plan must consider distributions from all plans maintained by the employer or any related entity within the meaning of sections 414(b), (c), (m) or (o) of the Code, but is not required to consider distributions from plans of unrelated employers or individual retirement accounts. Because both the plan and QI have the right to designate distributions as CRDs, it is possible that the total distributions to a QI from multiple sources may exceed $100,000. In that case, the excess amount will be includible in the QI's income in the year of distribution, may be subject to the 10 percent early distribution penalty and will not be eligible for repayment to an eligible retirement plan.

- ► **Consistency Rule for Participant Tax Treatment of CRDs**. A QI may either include the taxable portion of a CRD in income ratably over a three-year period that begins in the year of distribution or include the full amount of the distribution in income in the year of distribution; provided, that all CRDs must be treated consistently during the same year. The elected treatment may not be changed after the timely filing of the QI's tax return (including extensions) for the year of distribution. If the QI dies before the full-taxable amount of a CRD has been included in gross income, the remainder must be includible in the year of his death.

- ► **Plan Withholding and Reporting of CRDs**. CRDs are not subject to the 20% mandatory withholding requirement; but, rather are subject to voluntary withholding under section 3405(b) of the Code. This means a QI who takes a CRD is not required to receive a 402(g) notice. CRDs must be reported on Form 1099-R even if the QI recontributes the distribution to the plan in the same year. If no other appropriate code applies, the plan may use Code 2 (early, distribution exception applies) or Code 1 (early distribution no known exception) in box 7 of Form 1099-R. Clearly, option one is more consistent with a plan that allows CRDs.

- ► **Permitted Suspension of Deferral Elections Under a Nonqualified Deferred Compensation Plan**. A QI who receives a CRD and is a participant in a nonqualified deferred compensation plan may cancel his deferral election without violating section 409A of the Code.

Coronavirus-Related Distribution Repayments: A QI who receives a CRD may recontribute all, or any portion, of that distribution at any time during the following three-year period. If a QI who elected the three-year ratable income inclusion method repays a CRD for a tax year in the three-year period that exceeds the amount that is otherwise includible in gross income for that tax year, the excess amount of the repayment may be carried forward to reduce the amount of the CRD that is includible in gross income in the next tax year in the three-year period. Alternatively, the QI is permitted to carry back the excess amount of the repayment to a prior taxable year or years in which the QI included income attributable to a CRD. The QI will need to file an amended federal income tax return for the prior taxable year or years to report the amount of the repayment on Form 8915-E and reduce his gross income by the excess amount of the repayment.

Coronavirus Loan Clarifications: Under a new safe harbor, a qualified retirement plan will be treated as satisfying the requirements of the CARES Act if a QI's obligation to repay a plan loan is suspended for any period after March 27, 2020, through December 31, 2020 ("**suspension period**"). The loan repayments must resume after the end of the suspension period (i.e., by January 1, 2021), and the term of the loan may be extended by up to one year from the date the loan was originally due to be repaid.

> **Example:** On April 1, 2020, a QI, with a vested account balance of $40,000 borrowed $20,000 to be repaid in level monthly installments of $368.33 each over five years, with the repayments to be made by payroll withholding. The employer suspends payroll withholding repayments, for the period from July 1, 2020, through December 31, 2020, and no further repayments are made on the QI's loan until January 1, 2021 (when the balance is $19,477). At that time, repayments on the loan resume, with the amount of

each monthly installment reamortized to be $343.27 in order for the loan to be repaid by March 31, 2026 (which is the date the loan originally would have been fully repaid, plus one year).

Employers are not required to use the safe harbor and may use other reasonable methods to administer the loan suspension provisions of the CARES Act. For example, in a plan with a suspension period beginning April 1, 2020, each repayment that becomes due during the suspension period may be delayed to April 1, 2021 (the one-year anniversary of the beginning of the suspension period). After originally scheduled repayments for January through March of 2021 are made, the outstanding balance of the loan on April 1, 2021, including the delayed repayments with interest, may be reamortized over a period that is up to one year longer than the original term of the loan.

Navigating the Paycheck Protection Program (PPP) Loan Forgiveness Application, Lender Review and Government Audit Process, and Corresponding Tax Consequences

By: Juan F. Vasquez, Jr.,[1] Jaime Vasquez,[2] and Victor J. Viser,[3] Chamberlain, Hrdlicka, White, Williams & Aughtry, P.C.

The Paycheck Protection Program ("PPP") is part of the most prominent governmental response to the novel coronavirus and subsequent COVID-19 pandemic in 2020. The PPP was formed by a panoply of federal legislation, including the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act"),[4] the Paycheck Protection Program and Health Care Enhancement Act ("Enhancement Act"),[5] and the Paycheck Protection Program Flexibility Act of 2020 ("Flexibility Act") (collectively, the "PPP legislation").[6] Its impact and reach has been profound, having provided $525 billion in potentially forgivable PPP loans to 5.2 million sole proprietors, independent contractors, and businesses.[7] Every state, as well as six territories and the District of Columbia, has benefited from this program.[8] Despite this success, the PPP stopped accepting applications on August 8, 2020.[9] When the program closed, it had nearly $134 billion in remaining funds.[10]

Most businesses that have received PPP loans are preparing to begin or have already started the loan forgiveness application process. As of October 26, 2020, none of the PPP loans

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[4] 116 PL 136, Coronavirus Aid, Relief, and Economic Security Act (Mar. 27, 2020) (hereinafter "CARES Act"); 85 FR 20811 (Apr. 15, 2020). The CARES Act created the PPP and authorized the SBA to lend up to $349 billion in forgivable section 7(a) small business loans.

[5] 116 PL 139, Paycheck Protection Program and Health Care Enhancement Act (Apr. 24, 2020) (hereinafter "Enhancement Act"). The Enhancement Act appropriated another $310 billion to the PPP.

[6] 116 PL 142, Paycheck Protection Program Flexibility Act of 2020 (June 5, 2020) (hereinafter "Flexibility Act"). The Flexibility Act modified various aspects of the PPP in response to growing opposition to the program, including expanding the covered period from 8-weeks to 24-weeks for most borrowers and requiring that 60 percent of forgiven expenses be for payroll costs.

[7] Small Business Administration, *Paycheck Protection Program (PPP) Report*, 2 (Aug. 8, 2020).

[8] *Id*. at 5.

[9] *Id*. at 2.

[10] *Id*. at 9.

have been formally and fully forgiven by both the applicable lending bank and the Government. Applying for and receiving the appropriate amount of loan forgiveness is critical to the PPP's ultimate success as most businesses applied for PPP loans with the assumption that the loans would be forgiven. Any failure to attain appropriate loan forgiveness could result in businesses faltering, which could affect employees, their families, and communities as a whole.

Preparing for the tax consequences associated with forgiveness is essential. Certain important tax issues have been crystal clear since the beginning of the PPP regarding the potentially forgivable loans—namely that any portion of a PPP loan that is forgiven will not be included in the income of the applicable borrower. However, in other areas there is contradictory information about whether borrowers should work with their lender regarding the potential receipt of a Form 1099-C, *Cancellation of Debt*, and whether forgiven expenses are also deductible as ordinary business expenses. Therefore, it is crucial to understand how the loan forgiveness application process works, including submitting the application, the lender and SBA review process, and the tax consequences therefrom.

I. Tax Consequences of Loan Forgiveness

a. Form 1099-C, *Cancellation of Debt*

The PPP did not initially address whether lenders should issue Form 1099-C for amounts forgiven under a PPP loan. The CARES Act provides that borrowers are, "eligible for forgiveness of indebtedness" on a PPP loan with those amounts being excluded from gross income.[11] In general, section 6050P of the Code requires lenders to report discharged debt of $600 or more on a Form 1099-C whether or not the discharged debt is included in the borrower's gross income.[12] For purposes of this reporting requirement, the regulations provide that "indebtedness" means any amount owed to an applicable entity, including stated principal, fees, interest, penalties, administrative costs, and fines.[13] On its surface, section 6050P of the Code appears to apply to PPP loan forgiveness.

On September 22, 2020, the IRS announced that lenders should not file Form 1099-C for amounts forgiven under a PPP loan.[14] "When all or a portion of the stated principal amount of a [PPP loan] is forgiven because the eligible recipient satisfies the forgiveness requirements…an applicable entity is not required to, for federal income tax purposes only, and should not, file a Form 1099-C with the IRS or provide a payee statement to the eligible recipient…as a result of the qualifying forgiveness."[15] Filing the form could result in under reporting notices being issued to borrowers and cause confusion.[16] Therefore, borrowers should not expect their lender to file a Form 1099-C in connection with amounts forgiven under a PPP loan.

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[11] CARES Act § 1106(b), (i); 15 USC § 9005(b), (i).
[12] IRC § 6050P
[13] Treas. Reg. § 1.6050P-1(c).
[14] IRS Announcement 2020-12 (Sep. 22, 2020).
[15] *Id*.
[16] *Id*.

b. Ordinary Business Expense Deduction

As we previously discussed in the Spring edition of the Texas Tax Lawyer, while borrowers may exclude from gross income expenses that are forgiven under a PPP loan, the IRS intends to prohibit the deduction of ordinary business expenses to the extent they were paid with forgiven PPP loan funds.[17] The effect of the current IRS position as set forth in Notice 2020-32 is that borrowers cannot deduct business expenses they normally would have deducted but for the PPP loan, thereby diminishing the benefit associated with loan forgiveness. Shortly after the IRS disclosed its position in Notice 2020-32, Senate Finance Committee Chairman Chuck Grassley responded:

> "When we developed and passed the Paycheck Protection Program, our intent was clearly to make sure small businesses had the liquidity and the help they needed to get through [the Covid-19 pandemic]. Unfortunately, Treasury and the IRS interpreted the law in a way that's preventing businesses from deducting expenses associated with PPP loans. That's just the opposite of what we intended and should be fixed."[18]

The bipartisan Small Business Expense Protection Act of 2020 ("Senate Bill 3612") was introduced in the Senate shortly thereafter,[19] confirming the intent of Congress that business expenses forgiven as part of a PPP loan would be deductible under section 162 of the Code as ordinary business expenses.[20] There was measured expectation that Congress would remedy this issue in the intervening months.[21] However, the Flexibility Act, passed in June, did not address the deductibility of forgiven expenses and Senate Bill 3612 has stalled in the Senate Finance Committee and the House Committee on Ways and Means. Other potential legislative attempts to provide further PPP funding and associated clarifications have also stalled out recently in Congress.[22]

IRS Notice 2020-32 is still in effect as of the end of October, but may be subject to Court challenge and be entitled to little or no deference.[23] Nevertheless, borrowers will need to decide whether to comply with the notice or take the ordinary business deductions under the assumption that Congress will not address this issue. Further complicating tax planning is whether a fiscal

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[17] Juan F. Vasquez, Jr., Jaime Vasquez, and Victor J. Viser, *Who CARES About Tax Issues for Small Business: A Review of the Tax Forgiveness, Tax Deduction, and Other Tax Issues Associated with the CARES Act's Paycheck Protection Program ("PPP")*, TEX. TAX LAWYER (Spring 2020); *see also* IRS Notice 2020-32 (2020).
[18] Chuck Grassley, *Bipartisan Senators Introduce Bill to Clarify Small Business Expense Deductions Under PPP* (May 6, 2020); *Here are 3 Things to Know About the Extended Paycheck Protection Program*, ABC 13 EYEWITNESS NEWS HOUSTON (July 18, 2020) (Interview with Juan F. Vasquez, Jr.).
[19] S. 3612, *Small Business Protection Act of 2020*, 116th Cong. (May 5, 2020).
[20] *Id*.
[21] Juan F. Vasquez, Jr., Jaime Vasquez, and Victor J. Viser, *IRS Undermines Congressional Intent for Payroll Protection Program*, BLOOMBERG TAX DAILY TAX REPORT (July 23, 2020).
[22] S.3814, *RESTART Act*, 116th Cong. (May 21, 2020); HR.7197, *RESTAURANTS Act of 2020*, 116th Cong. (June 6, 2020); S.4321, *Continuing Small Business Recovery and Paycheck Protection Program Act*, 116th Cong. (July 27, 2020);
[23] Juan F. Vasquez, Jr., *Judicial Deference for Revenue Rulings in a Post-Mead World*, J. Tax Practice & Proc. (Aug/Sep 2004).

year borrower may take ordinary business deductions in 2020 for expenses that may ultimately be forgiven in 2021. Under the CARES Act, banks have 60 days from the receipt of the forgiveness application to make a forgiveness determination.[24] Banks are then required to forward their determination to the SBA, which in turn has 90 days to issue its determination regarding loan forgiveness.[25] The forgiveness determination, while for many taxpayers may be made in 2021, will effect 2020 returns. Is income formally excluded in 2020 or 2021? Deciding to disallow deductions when the amount of loan forgiveness has not been determined could result in the foregoing of available deductions if the borrower receives less than the full amount of forgiveness. Whether or not the borrower elects to take ordinary business deductions in 2020 inconsistent with Notice 2020-32, it should be ready to amend its 2020 return if necessary based on the final loan forgiveness determination and new legislative developments in 2021 that may relate back to 2020.

II. Submitting a Loan Forgiveness Application: SBA Forms 3508, 3508EZ, and 3508S

The SBA currently offers borrowers the ability to submit to their lender one of three loan forgiveness application forms: Form 3508, Form 3508EZ, or Form 3508S. The primary difference between the forms is how much detail they require borrowers to provide. While all borrowers may submit Form 3508, it is the most complex, requiring the borrower to calculate the Full-Time Equivalent (FTE) Reduction Test and Wage Reduction Test.[26] Because of the complexity of Form 3508, borrowers should first determine their eligibility for the simplified Forms 3508EZ or 3508S.

a. Form 3508EZ

Borrowers eligible for Form 3508EZ do not need to calculate the FTE Reduction Test and Wage Reduction Test on the form, but do need to certify that the tests were met or that they satisfy a safe harbor.[27] To be eligible to use Form 3508EZ, a borrower must have not reduced the salary or wages of any employee who worked during the covered period by more than 25 percent when compared to the first quarter of 2020.[28] Employees who were paid more than $100,000 annualized during any 2019 pay period are excluded from this requirement.[29]

In addition, the borrower either must have maintained its employment levels through the end of the covered period or can show that its business activity declined due to compliance with federal guidance related to the COVID-19 pandemic.[30] With regard to employment levels, the business cannot have reduced the number of employees or the average paid hours of employees

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[24] CARES Act § 1106(g).
[25] 85 FR 38304, 38306 (June 26, 2020).
[26] *See* Small Business Administration, *PPP Loan Forgiveness Application Form 3508* (June 2020) (hereinafter "Form 3508").
[27] Small Business Administration, *PPP Loan Forgiveness Application Form 3508EZ* (June 2020).
[28] Small Business Administration, *PPP Loan Forgiveness Application Form 3508EZ Instructions for Borrowers*, 1 (June 2020).
[29] *Id*.
[30] *Id*.

between January 1, 2020 and the end of the covered period.[31] The loss of an employee is not counted if the business was unable to rehire an individual employed before February 15, 2020 because such individual declined the offer and the business was unable to hire a similarly qualified employee.[32] With regard to a decline in business activity, the business must be able to demonstrate that it was unable to operate during the covered period at the same level of business activity as before February 15, 2020 due to compliance with federal guidance issued between March 1, 2020 and December 31, 2020, including from the Department of Health and Human Services, the Centers for Disease Control and Prevention, and the Occupational Safety and Health Administration.[33]

b. Form 3508S

Borrowers eligible for Form 3508S are exempt from the FTE Reduction Test and Wage Reduction Test, unlike Form 3508EZ, which requires the borrower to certify that it satisfied the Wage Reduction Test and either did not reduce employment levels or suffered a decline in business activity due to compliance with federal guidance related to the COVID-19 pandemic.[34] To be eligible to use Form 3508S, a borrower must have a PPP loan of $50,000 or less.[35] If multiple affiliated entities received PPP loans, then the aggregate amount of the affiliated entities' PPP loans cannot be $2 million or more.[36]

III. Expectations During the Lender's Review of the Loan Forgiveness Application

The PPP legislation did not adequately address how the loan forgiveness application process would look, but instead delegated that responsibility to the SBA.[37] The SBA has been slow to issue guidance on many aspects of the PPP, including the responsibilities of lenders during the review process. Because of this, businesses applied for and received PPP loans without knowing what was required to achieve forgiveness or its consequences.[38] In fact, the Flexibility Act was in part enacted as a response to growing concerns voiced by the business community over the program's lack of clarity.[39]

Starting in June, the SBA issued guidance describing how the loan forgiveness process would look. When a loan forgiveness application is submitted to the lender, it must confirm that the certifications contained in the application were made, that substantiating documentation has

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[31] *Id*.
[32] *Id*.
[33] *Id*.
[34] Small Business Administration, *PPP Loan Forgiveness Application Form 3508S* (Oct. 2020).
[35] Small Business Administration, *PPP Loan Forgiveness Application Form 3508S Instructions for Borrowers*, 1 (Oct. 2020).
[36] *Id*.
[37] CARES Act § 1106(k) (giving the SBA 30 days after the enactment of the CARES Act to issue guidance and regulations).
[38] Juan F. Vasquez, Jr., Jaime Vasquez, and Victor J. Viser, *IRS Undermines Congressional Intent for Payroll Protection Program*, BLOOMBERG TAX DAILY TAX REPORT (July 23, 2020).
[39] Juan F. Vasquez, Jr., Jaime Vasquez, and Victor J. Viser, *INSIGHT: Congress Adds 'Flexibility' to Loan Forgiveness and Corresponding Tax Consequences*, BLOOMBERG TAX DAILY TAX REPORT (June 5, 2020).

been submitted, and that the calculations are correct.[40] If the lender identifies errors in the borrower's calculation or material lack of substantiation in the borrower's supporting documents, SBA guidance directs the lender to work with the borrower to remedy the issue rather than simply denying the application.[41] This likely would entail requesting additional documentation from the borrower.

Borrowers can expect the lender to make a decision within 60 days after the lender receives a complete loan forgiveness application.[42] That decision may take the form of an:

1. approval, in whole or in part;

2. denial; or

3. if directed by SBA, a denial without prejudice due to a pending SBA review of the loan for which forgiveness is sought.[43]

In the case of a denial without prejudice, the borrower may subsequently request that the lender reconsider its application for loan forgiveness, unless the SBA has determined that the borrower is ineligible for a PPP loan.[44]

a. Approval by the Lender

If the lender determines that the borrower is entitled to complete or partial forgiveness, the lender must request payment from the SBA when it issues its decision.[45] The SBA will then remit within 90 days the loan forgiveness amount to the lender, plus any interest accrued through the date of payment, subject to SBA review of the PPP loan application and forgiveness application.[46] Note, the borrower should not expect the lender to file a Form 1099-C, *Cancellation of Debt*, for the forgiven amounts as the IRS has announced that Forms 1099-C should not be filed.[47]

b. Denial by the Lender

In the event that the lender denies loan forgiveness, it must provide the reason for its denial.[48] The lender must also notify the borrower in writing that its decision has been issued to the SBA, which the SBA may or may not review.[49] Fortunately, the borrower does have the ability to challenge a denial, if within 30 days it notifies the lender that it requests the SBA to

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[40] 85 FR 33010, 33013 (June 1, 2020).
[41] *Id*.
[42] CARES Act § 1106(g); 15 USC § 9005(c)(3).
[43] 85 FR 38304, 38310 (June 26, 2020).
[44] *Id*.
[45] *Id.* at 38306.
[46] *Id*.
[47] IRS Announcement 2020-12 (Sep. 22, 2020).
[48] 85 FR 38304, 38310.
[49] *Id*.

review the decision.[50] To reiterate, to challenge a denial by the lender, a borrower must tell the lender that it wants the SBA to review within 30 days of the decision. Within 5 days of receipt, the lender must then notify the SBA of the borrower's request for review.[51]

If the borrower does not request SBA review or the SBA declines the request, then the lender is responsible for notifying the borrower of the date on which the borrower's first payment is due.[52] If the SBA accepts a borrower's request for review, the SBA will notify both the borrower and the lender of the results of the review.[53] SBA guidance does not provide a time limit associated with this type of review.

IV. Preparing for a Government Audit

The SBA will review all PPP loans in excess of $2 million following the lender's submission of the forgiveness application.[54] However, loans that are $2 million or less may also be reviewed subject to the SBA's discretion.[55] This review is not only limited to the loan forgiveness application, but also covers initial eligibility for a PPP loan.[56] If a review is made, then the SBA will notify the lender in writing, and the lender must notify the borrower in writing within five business days.[57] To minimize the risk and potential consequences associated with an SBA audit, all borrowers should ensure that they have (i) satisfied the certification of need made on the initial PPP loan application and (ii) gathered comprehensive documentation substantiating eligible expenses.[58]

a. The Certification of Need

Borrowers must be ready to defend the certification of need they made when they applied for their PPP loans and potentially when they signed their promissory notes.[59] For borrowers that fail to satisfy the certification of need, the SBA may not pursue further administrative enforcement or refer the borrower to other governmental agencies if the loan is repaid in full.[60] Although, even if repaid in full, the borrower is still not shielded from all potential liability and is subject to enforcement for other violations. Therefore, it is best to ensure that the certification has been satisfied.

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[50] *Id*.
[51] *Id*.
[52] *Id*.
[53] *Id*.
[54] Small Business Administration, *Paycheck Protection Program Frequently Asked Questions*, #39 (Oct. 7, 2020) (hereinafter "SBA FAQ").
[55] *Id*.
[56] *Id*.
[57] 85 FR 33010.
[58] Juan F. Vasquez, Jr., Jaime Vasquez, and Victor J. Viser, *How to Prepare for a Paycheck Protection Program Loan Audit*, Hous. Bus. J. (Sep. 3, 2020).
[59] Juan F. Vasquez, Jr., Jaime Vasquez, and Victor J. Viser, *Preparing for a Potential Audit of Your Client's Paycheck Protection Program Loan*, TODAY'S CPA (July 2020).
[60] SBA FAQ #47.

The certification states, "That the uncertainty of current economic conditions makes necessary the loan request to support the ongoing operations of the eligible recipient."[61] To make the certification in good faith, borrowers must take into account two factors: (i) their business activity at the time the certification was made and (ii) whether they had access to other sources of liquidity, the use of which would not be significantly detrimental to their business.[62]

i. Business Activity

Importantly, for purposes of the good-faith certification, business activity is determined at the time the application was made.[63] A borrower will therefore want to show that its business activity was expected to be or actually was negatively affected by the COVID-19 pandemic when its application was signed. This should be done through a combination of financial records and analysis and secondary sources. With regard to financial records, year-over-year comparisons of revenue, sales, or other industry-specific metrics can be used to show the decline relative to 2019 and the days leading up to the application date to further emphasize any actual declines in business activity. With regard to secondary sources, borrowers should consider referencing trade publications or other industry examples of similarly situated taxpayers experiencing challenges due to the COVID-19 pandemic, and/or ordinances that prohibited business activity and/or specifically targeted the business. Note that multiple ordinances were likely in effect before the application date. Industry-wide or regional trends/projections published by trade associations around the application date may also be relevant. Finally, if applicable, a borrower should note whether it was experiencing, or expected to experience, reductions in the number of jobs, furloughs, or supply chain disruptions.

ii. Access to Liquidity

The second factor, access to liquidity, is also important. SBA guidance and Congressional action have directly addressed public companies, but not private companies. The SBA notes, "it is unlikely that a public company with substantial market value and access to capital markets will be able to make the required certification in good faith, and such company should be prepared to demonstrate to SBA, upon request, the basis for its certification."[64] The U.S. House of Representatives' Select Subcommittee on the Coronavirus Crisis (the "Coronavirus Subcommittee") sent a letter to Gulf Island Fabrication, Inc. ("Gulf Island Fabrication") in addition to four other public companies requesting that it return its $10 million PPP loan.[65] Gulf Island Fabrication has over 900 employees, reported revenue of more than $300 million in 2019, and is publicly traded on the NASDAQ stock exchange.[66] The Coronavirus Subcommittee reasoned that:

> "Since [Gulf Island Fabrication] is a public entity with a substantial investor base and access to capital markets, [the funds

[61] *Id*. at #31.
[62] *Id*.
[63] *Id*.
[64] *Id*.
[65] Select Subcommittee on the Coronavirus Crisis, House of Representatives, *Letter to Mr. Heo, Chief Executive Officer of Gulf Island Fabrication, Inc.* (May 8, 2020).
[66] *Id*.

> should be returned] immediately. Returning these funds will allow truly small businesses—which do *not* have access to alternative sources of capital—to obtain the emergency loans they need to avoid layoffs, stay in business, and weather the economic disruption caused by the coronavirus crisis."[67]

It is clear from the SBA and Congress assumes that public companies with access to capital markets, i.e., a publicly traded stock exchange, are generally deemed to have sufficient access to liquidity such that they should not make the certification of need in good faith. Of course, there may be exceptions to the rule if a public company is having financial difficulty or trouble accessing financial markets.

There has been no SBA guidance or Congressional action directly addressing when a private company would have sufficient access to liquidity such that it could not make the certification of need in good faith. This factor therefore remains relevant in determining whether the certification of need was accurate.[68]

Although there is no requirement to utilize a line of credit to secure a PPP loan, a private business with access to a line of credit may determine the amount of available credit at the application date. If the line of credit is not fully exhausted, the borrower could argue that its historical use is for a certain purpose and shifting the funds away from such purpose would be significantly detrimental to the business. For example, a hypothetical borrower might argue that it relies on the line of credit to purchase inventory before the busy summer season and to divert such funds to payroll would prevent the business from being able to meet demand. Additionally, the borrower may review the terms for the line of credit in case there are any restrictions that would be applicable. Thus, private companies have more opportunity than public companies to demonstrate why accessing certain sources of liquidity would be significantly detrimental to their businesses.

b. <u>Documenting Eligible Expenses</u>

Borrowers must be able to provide comprehensive documentation to substantiate all eligible expenses.[69] This documentation will be reviewed by the lender servicing the PPP loan and possibly the SBA during an audit. Potential loan forgiveness is primarily based on the total amount of eligible expenses made during the 8-week or 24-week covered period following the first disbursement of PPP loan funds,[70] subject to the requirement that 60% or more of such

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[67] *Id.*

[68] Juan F. Vasquez, Jr., Jaime Vasquez, and Victor J. Viser, *Preparing for and Defending Against a Potential Audit of Your Client's CARES Act PPP Loan*, NORTH DAKOTA CPA NEWSLETTER (Sep. 2020).

[69] CARES Act § 1106(e); *See also*, Juan F. Vasquez, Jr., Jaime Vasquez, and Victor J. Viser, *INSIGHT: Tax Issues Associated with the Paycheck Protection Program Loan Forgiveness Process*, BLOOMBERG TAX DAILY TAX REPORT (May 21, 2020).

[70] If a borrower received a PPP loan before June 5, 2020 it may choose either the 8-week or 24-week covered period. A borrower that receives a PPP loan on or after June 5, 2020 must use the 24-week covered period. Pub. L. 116-142, *Paycheck Protection Program Flexibility Act of 2020* § 3(b)(1) (June 5, 2020) (hereinafter "Flexibility Act"). *See also* Juan F. Vasquez, Jr., Jaime Vasquez, and Victor J. Viser, *INSIGHT: Congress Adds 'Flexibility' to Loan Forgiveness and Corresponding Tax Consequences*, BLOOMBERG TAX DAILY TAX REPORT (June 5, 2020).

expenses be for eligible payroll costs (paid or incurred during the covered period) and up to 40% of eligible expenses for non-payroll costs.[71]

With regard to payroll costs, the borrower must provide: bank account statements; tax forms, including federal payroll tax filings and state wage reporting and unemployment insurance tax filings; and payment receipts, cancelled checks, or account statements documenting employer contributions to employee health and retirement plans.[72]

With regard to non-payroll expenses, the borrower must provide documentation verifying the existence of the obligations and/or services prior to February 15, 2020 and eligible payments made during the covered period. For business mortgage interest payments, this includes a copy of the lender amortization schedule and receipts or cancelled checks or lender account statements from February 2020 and the months of the covered period through one month after the covered period.[73] For business rent or lease payments, this includes a copy of the current lease agreement and receipts or cancelled checks; or lessor account statements from February 2020 and from the covered period through one month after the end of the covered period.[74] For business utility payments, this includes a copy of invoices from February 2020 and those paid during the covered period; and receipts, cancelled checks, or account statements verifying eligible payments.[75]

c. PPP Enforcement

Government enforcement efforts have generally focused on egregious fraudulent activity. Criminal investigation and enforcement actions have only involved PPP loan applications and unauthorized or lavish expenditures thus far, but will likely include loan forgiveness applications as well going forward. Actions which may result in government enforcement action being taken include:

1. providing false information on the PPP loan application, loan forgiveness application, or supporting documentation; or

2. using PPP loan funds for non-authorized purposes such as luxury items, large bonuses, compensation above the maximum allowed (potentially up to $46,154 for each employee and up to $20,833 for each owner-employee), and significant investments.

In a representative example, the Department of Justice charged two businessmen with conspiracy to make false statements to influence the SBA and conspiracy to commit bank fraud.[76] The businessmen allegedly applied for PPP loans to pay employees of businesses that were not operating prior to the start of the COVID-19 pandemic and to pay employees of a business one applicant did not own.[77] They discussed via email the creation of fraudulent loan

[71] 85 FR 20811, 20814; SBA IFR 2020-37; Flexibility Act § 3(b)(1).
[72] CARES Act § 1106(e).
[73] Form 3508.
[74] *Id*.
[75] *Id*.
[76] Justice Department, *Two Charged in Rhode Island with Stimulus Fraud* (May 5, 2020) https://www.justice.gov/opa/pr/two-charged-rhode-island-stimulus-fraud.
[77] *Id*.

applications and supporting documentation in order to receive more than a half-million dollars in PPP loans.[78]

The Department of Justice also charged a reality TV personality with federal bank fraud after he diverted PPP loan proceeds for his own personal gain.[79] Within days of receiving the proceeds, the individual allegedly used more than $1.5 million in PPP funds on unauthorized purchases including a 2019 Rolls-Royce Wraith, jewelry, and child support.[80]

V. Conclusion

5.2 million sole proprietors, independent contractors, and businesses have taken advantage of the PPP and have received $525 billion in partially forgivable loans. The loan forgiveness process that these millions of borrowers must navigate, while not fully formed during the initial months of the PPP, has started to take shape through further legislative action and SBA guidance. Borrowers will have to determine what application to use based on the size of their loan and whether they have satisfied the FTE Reduction Test and Wage Reduction Test, or alternatively a safe harbor. They must also understand the steps they need to take in submitting their application and, if necessary, contesting the lender's decision. To protect against an SBA audit, borrowers must ensure that they have satisfied the certification of need and that they provide comprehensive documentation substantiating their eligible expenses. Finally, borrowers will need to plan for the uncertain tax consequences associated with loan forgiveness, including whether to deduct ordinary business expenses forgiven as part of their PPP loan. Identifying and understanding these issues is critical to successfully navigating the loan forgiveness process.

[78] *Id*.
[79] Justice Department, *Reality TV Personality Charged with Bank Fraud* (May 13, 2020) https://www.justice.gov/opa/pr/reality-tv-personality-charged-bank-fraud.
[80] *Id*. The Justice Department continues to indict individuals who provide false documentation/information during the application process or who misappropriate PPP funds for personal gain. See the indictments of William Sadleir (https://www.justice.gov/usao-sdny/pr/former-chairman-and-ceo-movie-production-company-arrested-fraud-charges), Baoke Zhang (https://www.justice.gov/opa/pr/software-engineer-charged-washington-covid-relief-fraud), and Hummer Mars (https://www.justice.gov/usao-sdny/pr/chinese-national-arrested-20-million-scheme-fraudulently-obtain-loans-intended-help).

Tax Law 2020: Criminal Tax Update
Author: Michael A. Villa, Jr.

Introduction

Internal Revenue Service Criminal Investigation ("IRS-CI") and the Department of Justice Tax Division ("DOJ Tax") are tasked with investigating and enforcing the criminal tax laws. Recent trends indicate 2019 and 2020 have been busy years. During 2019 alone, there were 1500 tax crime investigations initiated, 942 prosecutions recommended and 848 defendants sentenced in tax crime related cases.[1]

Some taxpayers may say, "it's just taxes, I'll pay it back, what's the big deal?" The "big deal" can be found in the numbers – in 2019, IRS-CI identified $1.8 billion in tax fraud.[2] Considering the impact of these types of numbers on the treasury, rest assured IRS-CI and DOJ Tax will root out tax crimes whenever possible to set an example for others who might think failure to pay taxes is just a civil monetary problem. Tax professionals can often glean the types of cases that could become criminal investigations by looking at prior prosecutions and reviewing public announcements from the IRS and/or DOJ Tax. IRS-CI recently outlined a few of their priority areas of investigation - employment tax fraud, the refund fraud program, and abusive tax schemes. This article highlights some of those public announcements and recent cases in an effort to inform professionals as to which areas of tax law require additional caution for taxpayers with potential problems.

[1] IRS: Criminal Investigation Annual Report 2019, at p.19. https://www.irs.gov/pub/irs-utl/2019_irs_criminal_investigation_annual_report.pdf
[2] *Id.*, at 13.

Prosecution of Employment Tax Cases

What does employment tax fraud look like compared to an employer who is simply late paying employment taxes for one or two quarters?[3] "Some of the most common forms include employee leasing, paying employees in cash, filing false payroll tax returns, and failing to file payroll tax returns ("pyramiding")."[4] Pyramiding occurs when a business or responsible person for the business withholds taxes from employees, but then intentionally fails to pay the taxes to the IRS.[5] After failing to pay the payroll taxes, the individual starts a new business and continues to fail to pay the employment taxes to the IRS.[6] In other cases, employers simply withhold taxes from their employees' paychecks and use the funds for their personal expenses.[7] However, it is important to note that responsible persons who willfully fail to collect or pay over employment taxes do not have to steal the funds for personal expenses for the case to rise to the level of a criminal offense.[8] If the responsible person or business owner willfully pays other business expenses with payroll taxes in lieu of paying them to the IRS, it could still be a criminal offense and be prosecuted as such. Employment taxes include federal income tax withholding, Social Security taxes, and federal unemployment taxes.[9]

During 2019, the IRS highlighted the importance of payroll tax compliance in a two-week campaign focused on legal actions and education visits.[10] IRS also noted that as of 2019, IRS-CI

[3] *Id.*, at 20.
[4] *Id.*
[5] *Id.*
[6] *Id.*
[7] *Id.*
[8] 26 U.S.C. § 7202.
[9] IRS: CI Annual Report 2019, at 21.
[10] IR-2019-71, April 11, 2019.

worked with the Department of Justice Tax Division and U.S. attorneys around the nation to focus on approximately 50 law enforcement actions related to employment tax crimes.[11]

In addition to public announcements, there are numerous recent examples of payroll tax cases being prosecuted and defendants who are sentenced to terms of imprisonment. For example, in *U.S. v. Krotz,*[12] the owner of a professional painting business was sentenced to 12 months and one day in prison for evading his individual income and employment tax liabilities from 2010-2016. On the employment tax liabilities, Mr. Krotz failed to pay over approximately $300,000 in employments taxes that were due.

Another example can be found in *U.S. v. Zheng*,[13] where the taxpayer owned and operated sewing and apparel businesses. Between 2002 and 2016, the taxpayer failed to file Forms 941 and pleaded guilty and admitted he did not pay approximately $688,234 in employment taxes due to the IRS. The taxpayer has not been sentenced as of the writing of this article.

In *U.S. v. Lorson,*[14] the president and CEO of an energy environmental services company was sentenced to five years in prison for not paying employment taxes and the taxpayer agreed to pay more than $3 million in restitution to the IRS. Mr. Lorson's sentence stems from his failure to pay employment taxes from 2010-2015 and instead used the money to fund advertising campaigns and to pay other creditors and expenses.

In *U.S. v. Minner*[15], the owner of a number of restaurants in Arkansas received a three year prison sentence for failing to pay between $500,000 and $1,500,000 in employment taxes. As you

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[11] *Id.*
[12] 2:19-cr-0038 (E.D. NY Nov. 22, 2019) (Doc. 20).
[13] 1:19-cr-262 (E.D. NY 2019).
[14] 5:18-cr-00088 (W.D. OK 2019).
[15] 3:2018-cr-30003 (W.D. Ark 2019).

can see from the above examples, when you have a client with multiple years of employment tax liabilities, this is the type of fact pattern that will gather the attention of IRS-CI and DOJ Tax for a potential criminal case and could result in a sentence of imprisonment.

Abusive Return Preparers Remain a Top Priority

Abusive Return Preparer Program investigations focus on the coordinated preparation and filing of false income tax returns by return preparers.[16] When the IRS sees a pattern where a preparer is often claiming inflated personal or business expenses, false deductions, excessive exemptions, and unallowable tax credits, it will rise to the level of a criminal investigation.

If the IRS observes troubling patterns with a return preparer's returns, it is possible IRS-CI will send in an undercover agent posing as a taxpayer to determine whether the return preparer is engaged in criminal conduct. One recent example of IRS-CI using undercover operations can be found in *U.S. v. Pastars.*[17] Lina Pastars ran a tax preparation business that collected higher fees from customers for falsely inflating their deductions, so that the taxpayers received a larger refund.[18] The investigation began when the IRS audited one of the preparer's taxpayer clients whose tax return claimed more than $30,000 in unreimbursed business expenses.[19] The taxpayer claimed Pastars had claimed the deductions without their consent or knowledge.[20] Based on these allegations, undercover IRS Criminal Investigation agents went to Pastars posing as clients for tax preparation.[21] The undercover agents were clear that they had no employee business expenses.[22]

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[16] IRS: CI Annual Report 2019, at 20.
[17] 2:17-cr-224 (W.D. WA).
[18] IRS: CI Annual Report 2019, at 41.
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *Id.*

The return preparer nevertheless claimed thousands of dollars in unreimbursed expenses so that the returns showed a refund.[23] The audio and video of these undercover exchanges were admitted into evidence and played for the jury.[24] Ms. Pastars was convicted and sentenced to one year in prison for 8 counts of aiding and assisting the preparation of false income tax returns.[25]

Criminal Prosecutions of Collection Cases

Tax professionals should take note that collection cases which have patterns of non-payment or taxpayers who are not cooperating with the IRS on payment arrangements could find themselves referred for a criminal investigation and prosecution. The IRS has publicly highlighted "[i]f you see that there's badges of fraud that are associated with . . . a collection case, what we want to do is emphasize that could be potentially a referral to CI."[26]

Collection cases can often provide examples of cases that are civil for long periods of time, even years, and then finally go criminal when the IRS has had enough with failed attempts to collect from a taxpayer who might be viewed as intentionally misrepresenting income, assets or ability to pay.

For example, in *U.S. v. Nagle,*[27] the taxpayer was sentenced to 36 months in prison for corruptly obstructing the due administration of the internal revenue laws. The taxpayer had failed to pay federal income taxes since 1999. The IRS, following normal collection protocol, filed liens and attempted to levy his paychecks and pension. In an attempt to obstruct the IRS's collection procedures, the taxpayer submitted false forms to his employer purporting to show he was exempt

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[23] *Id.*
[24] *Id.*
[25] *Id.*
[26] https://www.accountingtoday.com/news/irs-small-business-unit-pivots-to-cryptocurrency-enforcement
[27] 6:19-cr-173 (M.D. FL July 29, 2020)(Doc. 132).

from federal withholding, submitted checks to the IRS from a closed bank account, and threatened to file suits and complaints against IRS collection officers.

Although Mr. Nagle's actions may seem extraordinary, a collection case can easily go from a civil matter to criminal when a taxpayer has a pattern of what might be perceived as evasive behavior when it comes to work with IRS Collection.

Another example of an IRS collection case gone awry for the taxpayer and his attorney can be found in *U.S. v. Selgas*.[28] Earlier this year, a federal jury in Dallas convicted Texas attorney, John Green, and his client Thomas Selgas, who was the taxpayer at issue, for conspiring to defraud the United States.[29] The jury found Selgas conspired with Green to obstruct the IRS from assessing and collecting Selgas' taxes.[30] Selgas owed approximately $1.1 million in outstanding taxes for multiple tax years that he refused to pay. When the IRS made efforts to collect the outstanding taxes, Selgas allegedly concealed funds by using Green's Interest on Lawyers Trust Account instead of using accounts in his own name.[31] The odyssey of the Selgas case stretched from 2007 to 2017 and culminated with guilty verdicts in 2020. Tax professionals should be aware that civil collection cases that stretch long periods of time with any additional factors that might be viewed as badges of fraud (i.e. using nominee accounts or concealing funds or assets) will certainly gain the interest of IRS-CI and DOJ Tax.

[28] 3:18-cr-356 (NDTX).
[29] https://www.justice.gov/opa/pr/jury-finds-texas-attorney-and-client-guilty-conspiring-defraud-internal-revenue-service
[30] *Id.*
[31] *Id.*

Investigation and Prosecution of Abusive Tax Schemes

IRS-CI and DOJ Tax are vigorously pursuing a variety of perceived abusive tax schemes. These are investigations of promoters and taxpayers who willfully implement domestic and offshore tax schemes in violation of the tax laws. One place to identify potentially abusive tax positions is the IRS's Dirty Dozen List.[32] The Dirty Dozen List contains transactions that the IRS believes have the potential to be abusive tax avoidance transactions and warns taxpayers to either avoid these transactions or tread carefully if entering into one of these transactions because the IRS is likely to audit the position, or worse – criminally investigate those who utilize the transactions.

One such example of a purported abusive tax scheme is the syndicated conservation easement. The IRS has repeatedly announced throughout 2019 and 2020 that it is aggressively pursuing these transactions, both civilly and criminally.[33] The IRS previously issued Notice 2017-10, which designated certain syndicated conservation easements as listed transactions.[34] The Notice specifically "listed transactions where investors in pass-through entities receive promotional material offering the possibility of a charitable contribution deduction worth at least two and half times their investment. In many transactions, the deduction taken is significantly higher than 250 percent of the investment."[35]

Abusive tax schemes raise interesting procedural issues for taxpayers and those engaged in marketing or preparing returns associated with the transactions. Specifically, you will often see

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[32] https://www.irs.gov/newsroom/abusive-tax-shelters-trusts-conservation-easements-make-irs-2019-dirty-dozen-list-of-tax-scams-to-avoid
[33] IR-2019-182
[34] *Id.*
[35] *Id.*

governmental attacks on multiple fronts such as civil promoter investigations,[36] criminal investigations and audits of the underlying transaction that are all occurring simultaneously. IRS-CI "has developed a nationally coordinated program to combat . . . abusive tax schemes. CI's primary focus is on the identification and investigation of the tax scheme promoters as well as those who play a substantial or integral role in facilitating, aiding, assisting, or furthering the abusive tax scheme (e.g., accountants, lawyers). Secondarily, but equally important, is the investigation of investors who knowingly participate in abusive tax schemes."[37] As demonstrated by the IRS's public announcements, tax professionals who engage in transactions that the IRS deems to be abusive should proceed with caution.

<u>Conclusion</u>

This article highlights only a few of the recent areas of interest on the criminal tax landscape. Tax professionals would be well advised to be familiar with the issues that IRS-CI and DOJ-Tax identify as critical enforcement areas. By doing so, you will be able to fully advise a client of what possible outcomes lie ahead. For example, if you have a client who comes to you with numerous unpaid employment tax liabilities, this taxpayer may believe he or she can continue to drag the process out civilly while they get their affairs in order. However, as we know from the recent case law and IRS announcements, that could be a dangerous proposition – as employment tax cases are ripe for criminal referral. By advising the client that he or she has real criminal

[36] *See e.g.* 26 U.S.C. § 6700, *et seq.*

[37] https://www.irs.gov/compliance/criminal-investigation/overview-abusive-tax-schemes#:~:text=IRS%20Criminal%20Investigation%20(CI)%20has,combat%20these%20abusive%20tax%20schemes.&text=Secondarily%2C%20but%20equally%20important%2C%20is,participate%20in%20abusive%20tax%20schemes.

exposure, it may light the necessary fire to do everything possible to cooperate with the IRS on payment arrangements and collection issues.

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

C. Reasonable Compensation

D. Miscellaneous Deductions

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

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

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

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

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

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

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

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

Example 1.

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

Example 2.

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

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

Example 3.

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

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

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

Entertainment expenses. With respect to § 274(a) *entertainment expenses*, Prop. Reg. § 1.274-11 restates the new deduction-disallowance rule under § 274(a), including the application of the disallowance rule to dues or fees relating to any social, athletic, or sporting club or organization. The proposed regulations substantially incorporate the existing definition of "entertainment" in § 1.274-2(b)(1), with minor modifications to remove outdated language. The proposed regulations also confirm that the nine exceptions to § 274(a), which are set forth in § 274(e) (e.g., entertainment costs or club dues reported as employee-compensation, recreational expenses for employees, employee or stockholder business meeting expenses, etc.) continue to apply to entertainment expenses. Importantly, like Notice 2018-76, the proposed regulations clarify that separately-stated, separately-charged food or beverage expenses are not considered entertainment expenses subject to disallowance under § 274(a).

Business meal expenses. With respect to § 274(k) *business meal expenses*, Prop. Reg. § 1.274-12(a)(1)-(3) incorporates the guidance published in Notice 2018-76 as well as incorporates other statutory requirements taxpayers must meet to deduct 50 percent of an otherwise allowable business meal expense. For instance, under § 274(k) the food or beverage expense at a business meal must not be lavish or extravagant under the circumstances, and the taxpayer, or an employee of the taxpayer, must be present at the furnishing of the food or beverages. Further, the expense must be a § 162 ordinary and necessary expense paid or incurred during the taxable year in carrying on any trade or business; and the food and beverages must be provided to a current or potential business customer, client, consultant, or similar business contact.

Further guidance. In addition, new Prop. Reg. § 1.274-12 goes beyond Notice 2018-76 in several respects. ***One***, even though the rules for travel expenses were not amended by the 2017 Tax Cuts and Jobs Act, new Prop. Reg. § 1.274-12(a)(4) provides further guidance under § 274(n) regarding food and beverage expenses paid or incurred with respect to travel, including the substantiation requirements in § 274(d). Accordingly, the proposed regulations provide that such travel meal expenses, in addition to being subject to certain special rules in § 274(m) (cruise expenses, education travel expenses, and spouse and dependent travel expenses), are subject to the 50 percent deduction limitation of § 274(n). ***Two***, new Prop. Reg. § 1.274-12 clarifies the treatment of food or beverages provided to employees as *de minimis* fringe benefits excludable by employees under § 132(e). Under Reg. § 1.132-7, employee meals provided on a nondiscriminatory basis by an employer qualify under § 132(e) if (1) the eating facility is owned or leased by the employer; (2) the facility is operated by the employer; (3) the facility is located on or near the business premises of the employer; (4) the meals furnished at the facility are provided during, or immediately before or after, the employee's workday; and (5) the annual revenue derived from the facility normally equals or exceeds the direct operating costs of the facility. Such employer-provided meals previously were fully deductible by the employer and fully excludable by employee; however, the 2017 Tax Cuts and Jobs Act, § 13304, amended Code § 274(n) to limit the employer's deduction to 50 percent of the cost of employee meals provided at an employer-operated eating facility (unless, as discussed immediately below, an exception applies). Beginning in 2026, the costs of such employer-provided meals will be *entirely disallowed* as deductions pursuant to new Code § 274(o). ***Three***, new Prop. Reg. § 1.274-12(c) addresses the six exceptions to the 50 percent food and beverage disallowance rule set forth in § 274(n)(2) (e.g., food or beverage expenses treated as compensation to employee, recreational expenses for employees, etc.). ***Four***, in response to practitioner concerns, Prop. Reg. § 1.274-12(c) also addresses by way of examples several common scenarios, including the deductibility of expenses for (i) food or beverages provided to food service workers who consume the food or beverages while working in a restaurant or catering business; (ii) snacks available to employees in a pantry, break room, or copy room; (iii) refreshments provided by a real estate agent at an open house; (iv) food or beverages provided by a seasonal camp to camp counselors; (v) food or beverages provided to employees at a company cafeteria; and (vi) food or beverages provided at company holiday parties and picnics.

E. Depreciation & Amortization

F. Credits

1. Take some COVID-19 sick leave (or maybe some family leave) on the Treasury! The Families First Coronavirus Response Act provides refundable tax credits that reimburse (smaller?) employers for providing paid sick and family leave wages to their employees. The Families First Coronavirus Response Act (FFCRA), signed into law on March 18, 2020, authorizes refundable tax credits to eligible employers to offset the cost of paid sick and family leave provided to employees for COVID-19 related leave. Under the FFCRA, eligible employers must offer paid leave to their employees under two separate sets of temporary, emergency provisions. First, the Emergency Paid Sick Leave Act (EPSLA), which is Division E of the FFRCA, entitles workers to as much as 80 hours of paid sick leave ("qualified sick leave wages") under specific circumstances related to COVID-19. Second, the Emergency Family and Medical Leave Expansion Act ("Expanded FMLA"), which is Division C of the FFRCA, entitles workers to paid family and medical leave ("qualified family leave wages") again under specified circumstances related to COVID-19. Eligible employers who are required to pay employees for leave under these emergency provisions are allowed a tax credit to fully refund the cost of the leave that is required under these emergency provisions. The amount of these tax credits generally is increased by any qualified health plan expenses allocable to and the eligible employer's share of Medicare tax on the qualified leave wages.

Eligible Employers. An eligible employer (referred to in the legislation as a "covered employer") is generally defined in § 5110(2)(B) of the FFRCA as a private business, including a tax-exempt organization, that employs fewer than 500 employees. In general, a business has fewer than 500 employees if, at the time the relevant leave is taken, the business employs less than 500 *full and part time* employees. Federal employees generally are covered by Title II of the Family and Medical Leave Act (FMLA). While the FMLA generally was not amended by the FFCRA, federal employees covered by Title II of the FMLA are covered by the FFRCA's paid sick leave provision. Small businesses employing fewer than 50 employees may qualify for exemption from the FFCRA's requirement to provide paid leave to employees required to take leave due to a school closure or when child care becomes unavailable.

Paid Sick Leave. Under the EPSLA (§ 5102(a) of the FFRCA), an employer is required to provide paid sick leave to an employee if the employee is unable to work (or telework) because the employee needed leave for any one of the following circumstances:

(1) The employee is subject to a federal, state, or local quarantine or isolation order related to COVID-19.

(2) The employee has been advised by a health care provider to self-quarantine due to concerns related to COVID-19.

(3) The employee is experiencing symptoms of COVID-19 and seeking a medical diagnosis.

(4) The employee is caring for an individual who is subject to an order as described in subparagraph (1) or has been advised as described in paragraph (2).

(5) The employee is caring for a son or daughter if the school or place of care of the son or daughter has been closed, or the child care provider of such son or daughter is unavailable, due to COVID-19 precautions.

(6) The employee is experiencing any other substantially similar condition specified by the Secretary of Health and Human Services.

The first three circumstances listed above generally are situations in which an employee's own health needs are in question. The following two circumstances are situations in which the employee is unable to work because he or she must care for another person, such as a child or dependent of the employee. Under § 5102(b)(2)(A) of the FFCRA, full-time employees who qualify under any of the circumstances above are entitled to receive up to 80 hours or 10 days of paid sick time. According to § 5102(b)(2)(B) of the FFRCA, a part-time employee is entitled to receive sick time equal to the average number of hours the employee worked over a two-week period. Section 3012 of the FFRCA, which amends the FMLA for this purpose, an "eligible employee" is an employee who has been employed for at least 30 calendar days. Paid sick time for all employees, according to FFCRA § 5110(b)(5), generally is compensated at an amount equal to the employee's regular rate of pay. The rate of pay for sick leave, however, is limited to a maximum amount depending on whether the employee qualifies under the first three or last three circumstances set out above. If the employee qualifies under one of the first three circumstances (applying to his or her own health needs), the rate of compensation for sick leave caps out at $511 per day and $5,110 total. The amount of compensation is lower if the employee qualifies under circumstances (4)-(6) above. In those circumstances, the rate of pay is 2/3 of the employee's regular rate of pay or, if higher, the federal or state applicable minimum wage up to $200 per day and $2,000 in the aggregate. Thus, total sick leave wages in circumstances (4)-(6) caps out at $200 per day or $2,000.

Paid Family Leave Credit. The FFRCA provides a tax credit for employers who pay qualified family leave wages to employees who cannot report to work or work remotely in order to care for a son or daughter if the school or place of care of the child has been closed, or if the child care provider is unavailable, due to COVID-19 precautions. These reasons match circumstance (5) listed above which is the only relevant and qualifying circumstance for family leave wages. In general, according to FFCRA § 7003(c), "qualified family leave wages" means wages that an eligible employer must pay to an eligible employee under the Expanded FMLA provisions of the FFRCA. Employees taking family leave are paid at 2/3 of their regular rate or 2/3 of the applicable minimum wage, whichever is higher. The amount of "qualified family leave wages" that are taken into account for purposes of the credit, however, are limited to $200 per day per employee. There is also a $10,000 per employee maximum aggregate allowed of qualified family leave wages that may be taken into account for purposes of the credit. Under this math, as much as ten weeks of family leave wages can be received by an employee. Note, however, that the first ten days of leave taken may be without pay. The reason for this rule is that it is anticipated that in the first ten-day period, the employee may receive qualified sick leave wages under the EPSLA as described above. Alternatively, an employee may choose to receive paid leave under the eligible employer's regular sick leave, vacation leave, or other policies allowing for paid time off. Thus, after ten days, the eligible employer must provide the employee with qualified family leave wages for up to ten weeks. In summary, employees taking family leave are paid at 2/3 their regular rate or 2/3 the applicable minimum wage, whichever is higher, up to $200 per day and $12,000 in the aggregate (over a twelve-week period—two weeks of paid sick leave followed by up to ten weeks of paid expanded family and medical leave).

Sick Leave and Family Leave Credit for Employers. An eligible employer who is required to pay qualified sick leave wages or qualified family leave wages under the FFCRA is entitled to a fully refundable tax credit. The amount of the credit is equal to the amount of qualified sick leave wages and qualified family leave wages paid to employees from April 1, 2020, through December 31, 2020. The credit is increased dollar-for-dollar by the employer's payment of qualified health plan expenses that relate to the employee's sick leave or family leave payments and the employer's share of the Medicare tax imposed on those payments.

Employers that pay qualified sick leave wages or qualified family leave wages are allowed to forego payment of federal employment taxes in an amount that is equal to the wages and qualified health plan expenses. In other words, when an employer pays its employees, the employer generally withholds and deposits federal income taxes on the employee's wages and the employee's share of Social Security and Medicare taxes. The employer also deposits the employer's share of Social Security and Medicare taxes. In depositing these employment taxes on a quarterly basis, employers must file employment tax returns (Form(s) 941, 943, 944, or CT-1) with the IRS. Eligible employers who pay qualified sick leave wages or qualified family leave wages that are eligible for the credit may retain (e.g., not remit) an amount of the employment taxes equal to the amount of qualified sick leave wages and qualified family leave wages paid during that quarter (plus certain related health plan expenses and the employer's share of the Medicare taxes on the qualified leave wages) rather than deposit these amounts with the IRS. If retention of these employment taxes is not sufficient to compensate the employer for the qualified leave wages, qualified health plan expenses, and the employer's share of Medicare taxes due, employers may additionally file for advance payments from the IRS. Stated otherwise, if quarterly employment taxes due in a particular quarter are less than the amount of the credit for which the employer is eligible, the employer may receive the remaining credit in advance by filing Form 7200. As discussed below, the FFCRA also provides similar credits for qualified self-employed taxpayers in similar circumstances. However, self-employed individuals are not eligible for advance payments.

Substantiation. To claim the tax credit for qualified sick leave wages or qualified family leave wages, an employer must maintain documentation supporting the amounts paid to each employee. Employers must retain all Forms 941, Employer's Quarterly Federal Tax Return, and Forms 7200, Advance Of Employer Credits Due to Covid-19, and any other relevant tax filings with the IRS that relate to the credit.

Self-Employed Individuals. The FFCRA makes also provides a tax credit for eligible self-employed individuals. Under § 1402 of the FFRCA, an "eligible self-employed individual" is defined as an individual who regularly carries on any trade or business who would otherwise be entitled to receive qualified sick leave wages or qualified family leave wages if the individual were an employee of an eligible employer as described above. Like an eligible employer, an eligible self-employed individual is allowed a credit to offset their federal self-employment tax in an amount equal to their "qualified sick leave equivalent amount" or "qualified family leave equivalent amount." There are specific and different methods to calculate these two amounts.

With respect to calculating the "qualified sick leave equivalent amount," § 7002(c)(1) of the FFRCA provides that an eligible self-employed individual who is unable to work or telework under circumstances (1)-(3) listed above in relation to employee sick leave wages qualifies for an amount of sick leave equal to the number of days during the taxable year that the individual cannot perform services in the applicable trade or business multiplied by the lesser of $511 or 100 percent of the "average daily self-employment income" of the individual for the taxable year. Average daily self-employment income is equal to net earnings from self-employment for the year divided by 260. Net earnings from self-employment are based on gross income less ordinary and necessary trade or business expenses of the self-employed individual's trade or business. Similar to the method described above for employee sick leave, if the self-employed individual is unable to work or telework because of one of circumstances (4)-(6) above, the qualified sick leave equivalent amount is equal to the number of days during the taxable year that the individual cannot perform services in the applicable trade or business for one of the three above reasons, multiplied by the lesser of $200 or 2/3 of the "average daily self-employment income" of the individual for the taxable year. Regardless of the manner in which a person qualifies, the maximum number of days a self-employed individual may take into account in determining the qualified sick leave equivalent amount is ten days.

The "qualified family leave equivalent amount" is defined as an amount equal to the number of days (up to 50) during the taxable year that the self-employed individual cannot perform services (similar to the above described family leave), multiplied by the lesser of: (1) $200, or (2) 2/3 of the average daily self-employment income of the individual for the taxable year.

A self-employed individual may receive both qualified sick leave wages and qualified family leave wages. However, if a self-employed individual is both self-employed and also works as an employee of another, there cannot be a double benefit. If a self-employed individual receives sick leave wages from a separate employer, such individual's qualified sick leave equivalent amount must be offset or reduced by the sick leave wages received from his or her employer. Thus, a self-employed individual's qualified sick leave equivalent must be reduced (but not below zero) by up to $5,110 if circumstances (1) through (3) apply or $2,000 in the case of circumstances (4)-(6). Similarly, a self-employed individual must reduce any qualified family leave equivalent amount by the amount by which the sum of the qualified family leave equivalent amount and the qualified family leave wages received by the exceed $10,000. The IRS has provided guidance on its website in the form of frequently asked questions entitled COVID-19-Related Tax Credits: Special Issues for Employees and Additional Questions FAQs. Q&A 64 provides an example that illustrates this calculation:

> Assume that an eligible self-employed individual's qualified family leave equivalent amount is $5,000, but the individual also works for an Eligible Employer and received qualified family leave wages of $9,000 to care for the individual's child while school was closed due to COVID-19. The individual's qualified family leave equivalent amount would be reduced by $4,000 [i.e., ($5,000 + $9,000) - $10,000], resulting in a credit for the qualified family leave equivalent of $1,000 [i.e., $5,000 - $4,000].

Self-employed individuals generally make quarterly estimated tax payments. Accordingly, a self-employed individual may not recover leave amounts by not remitting employment tax. Self-employed individuals instead must claim the credit on their 2020 federal income tax returns. It is also possible for a self-employed individual to estimate and properly adjust their quarterly estimated tax payments downward to solve or improve cash flow.

G. <u>Natural Resources Deductions & Credits</u>

H. <u>Loss Transactions, Bad Debts, and NOLs</u>

I. <u>At-Risk and Passive Activity Losses</u>

III. INVESTMENT GAIN AND INCOME

IV. COMPENSATION ISSUES

A. <u>Fringe Benefits</u>

B. <u>Qualified Deferred Compensation Plans</u>

1. It's okay to discriminate on the basis of age! The § 72(t) 10 percent for those receiving distributions prior to age 59-½ does not violate the Fifth Amendment's Due Process Clause. Conard v. Commissioner, 154 T.C. No. 6 (3/10/20). In general, under § 72(t)(1), a taxpayer who receives a distribution from a qualified retirement plan must pay an additional tax equal to 10 percent of the total distributions for that year. Pursuant to § 72(t)(2)(A), the 10 percent additional tax, commonly referred to as a penalty, does not apply to specified types of distributions, including those made to a taxpayer who has attained the age of 59-½ or who is disabled (as defined in § 72(m)(7)) at the time of the distribution. The taxpayer in this case, Ms. Conard, was not yet age 59-½ nor was she eligible for any other exceptions to the penalty when she received nine distributions totaling $61,777 from her qualified retirement plan in 2008. While Ms. Conard properly reported the total amount of the distributions, she neither reported nor paid the additional 10 percent tax. Instead, Ms. Conard attached a statement to her Form 1040 taking the position that the additional tax was abitrary and capricious. The IRS determined a deficiency of $6,177 attributable to the additional 10 percent tax on premature distributions. Representing herself in the Tax Court, Ms. Conard argued that the exception for distributions made to taxpayers who are at least age 59-½ violated "the U.S. Constitution's guarantee of equal treatment under the law."

Constitutional Analysis. The Due Process Clause of the Fifth Amendment to the United States Constitution provides that no person shall be "deprived of life, liberty, or property, without due process of law." The Due Process Clause imposes on the federal government requirements similar to those that the Equal Protection Clause of the Fourteenth Amendment imposes on the individual states. *See, Regan v. Taxation With Representation of Wash*., 461 U.S. 540, 542 n.2 (1983). Section 1 of the Fourteenth Amendment prohibits states from "deny[ing] to any person within its jurisdiction the equal protection of the laws." In determining whether Ms. Conard's right to equal protection was violated in this case, the Tax Court (Judge Toro) relied on the Seventh Circuit's framework in *Estate of Kunze*, 233 F.3d 948 (7th Cir. 2000), reasoning that where a statute affects economic rights and neither infringes on a substantive constitutional right nor discriminates on the basis of a suspect classification such as race, the statute is subject to judicial scrutiny only under the lower rational basis test. *Estate of Kunze*, 233 F.3d at 954. Under that test "a statute will be sustained if the legislature could have reasonably concluded that the challenged classification would promote a legitimate state purpose." *Id*. (citing *Exxon Corp. v. Eagerton*, 462 U.S. 176, 195-96 (1983)). According to *Estate of Kunze*, legislatures have broad authority to enact tax statutes that create distinctions and classifications among taxpayers and the Constitution does not require either perfect equality or absolute logical consistency as between taxpayers. With respect to a tax statute, there is a presumption of constitutionality that may be overcome only by demonstrating that a classification "is a hostile and oppressive discrimination against particular persons and classes." *Regan*, 461 U.S. at 547.

Court's Reasoning. Judge Toro applied the framework discussed above in evaluating Ms. Conard's equal protection challenge to the additional tax imposed by § 72(t) and concluded that the proper standard of review is the rational-basis test. Under this test, the issue narrowly becomes whether the classification bears a reasonable relationship to some legitimate government purpose. *See Ruggere v. Commissioner*, 78 T.C. 979, 987 (1982). The court turned to the legislative history of § 72(t). In proposing the enactment of § 72, the Senate Finance Committee reasoned that "[t]he absence of withdrawal restrictions in the case of some tax-favored arrangements allows participants in those arrangements to treat them as general savings accounts with favorable tax features rather than as retirement savings arrangements." S. Rept. No. 99-313, at 612 (1985), 1986-3 C.B. (Vol. 3) 612 (1985). The Committee explained its reasoning as follows:

> Although the committee recognizes the importance of encouraging taxpayers to save for retirement, the committee also believes that tax incentives for retirement savings are inappropriate unless the savings generally are not diverted to nonretirement uses. One way to prevent such diversion is to impose an additional income tax on early withdrawals from tax-favored retirement savings arrangements in order to discourage withdrawals and to recapture a measure of the tax benefits that have been provided. Accordingly, the Committee believes it appropriate to apply an early withdrawal tax to all tax-favored retirement arrangements. * * * S. Rept. No. 99-313, supra at 613, 1986-3 C.B. (Vol. 3) at 613.

Judge Toro reasoned that this explanation, among other explanations in the legislative history, are entirely rational. If taxpayers were allowed to withdraw amounts from qualified retirement plans prior to their retirement years, such withdrawals could be "diverted to nonretirement uses," which would frustrate the congressional objective of encouraging taxpayers to save for retirement. Thus, although § 72(t) provides different rules for differently situated taxpayers, it did not violate the taxpayer's constitutional rights. Because Ms. Conard was not yet age 59-½ and did not qualify for any other exception, she was subject to the additional 10 percent tax of § 72(t).

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

D. Individual Retirement Accounts

V. PERSONAL INCOME AND DEDUCTIONS

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

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

a. In response to taxpayer concerns regarding the effective date of the proposed regulations on the calculation of built-in gains and built-in losses under § 382(h), the Treasury Department and the IRS have provided a delayed effective date and transition relief for eligible taxpayers. Revised Applicability Dates for Regulations Under Section 382(h) Related to Built-in Gain and Loss, 85 F.R. 2061 (1/14/20). The preamble to the proposed regulations published in the Federal Register on September 10, 2019 (2019 proposed regulations), indicated that Treasury and the IRS proposed to withdraw certain IRS notices, including Notice 2003-65, 2003-2 C.B. 747, and that the withdrawal would be effective on the day after the proposed regulations are published as final regulations in the Federal Register. The 2019 proposed regulations further provided that they generally would be effective for ownership changes occurring after the date on which they are published as final regulations in the Federal Register. Section V of Notice 2003-65 provides that taxpayers may rely on either of two safe harbor approaches for applying § 382(h) to an ownership change "prior to the effective date of temporary or final regulations under section 382(h)." Taxpayers and practitioners expressed two concerns regarding these effective dates: (1) they would impose a significant burden on taxpayers who are evaluating and negotiating business transactions because of uncertatinty regarding both when the transactions will close and the date on which the final regulations will be published, and (2) as stated in the preamble, "transition relief limited to transactions for which a binding agreement is in effect on or before the applicability date of final regulations would be inadequate, because pending transactions regularly are modified or delayed prior to closing." In response to these concerns, Treasury and the IRS have withdrawn the text of Prop. Reg. §§ 1.382-2(b)(4) and 1.382-7(g) contained in the 2019 proposed regulations and have proposed revised effective dates. Under the revised rules, subject to two exceptions, Prop. Reg. § 1.382-2(b)(4) provides that the proposed regulations apply to any ownership change that occurs after the date that is 30 days after the date on which on which final regulations are published in the Federal Register. The first exception is that, according to the preamble, Treasury and the IRS expect that Prop. Reg. § 1.382-7(d)(5) will be made final before other portions of the 2019 proposed regulations as part of the Treasury Decision that finalizes proposed regulations issued under § 163(j). Prop. Reg. § 1.382-7(d)(5) provides that certain carryforwards of business interest expense disallowed under § 163(j) are not treated as recognized built-in losses under § 382(h)(6)(B) if they were allowable as deductions during a specified five-year recognition period. The second exception, set forth in Prop. Reg. § 1.382-7(g)(2), is that the final regulations would not apply to certain ownership changes that occur *after* the generally applicable effective date (30 days after the date on which on which final regulations are published in the Federal Register) if the ownership change occurs in one of five specified circumstances. For transactions to which the final regulations do not apply (because of either the 30-day delayed effective date or the transition relief for ownership changes occurring after the delayed effective date), Notice 2003-65, including its safe harbors, would remain applicable. For ownership changes that occur after the delayed effective date and to which the final regulations would not apply pursuant to the transition relief, taxpayers can elect instead to apply the final regulations.

C. <u>Liquidations</u>

D. <u>S Corporations</u>

E. <u>Mergers, Acquisitions and Reorganizations</u>

F. <u>Corporate Divisions</u>

G. <u>Affiliated Corporations and Consolidated Returns</u>

H. <u>Miscellaneous Corporate Issues</u>

VII. PARTNERSHIPS

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

X. TAX PROCEDURE

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

B. <u>Discovery: Summonses and FOIA</u>

C. <u>Litigation Costs</u>

D. <u>Statutory Notice of Deficiency</u>

E. <u>Statute of Limitations</u>

F. <u>Liens and Collections</u>

1. Congress has codified the waiver of fees for low-income taxpayers submitting an offer-in-compromise. Generally, under § 7122(c)(1)(A), a taxpayer making a lump-sum offer-in-compromise must submit with the offer a payment of 20 percent of the amount offered. A taxpayer also must pay a user fee (currently $186) for processing the offer-in-compromise. Through administrative guidance, the up-front partial payment and the user fee are waived for low-income taxpayers. The Taxpayer First Act, Pub. L. No. 116-25, § 1102, amends § 7122(c) by adding new § 7122(c)(3), which codifies these waivers. Section 7122(c)(3) provids that the up-front partial payment and user fee do not apply to an offer-in-compromise submitted by a taxpayer whose adjusted gross income, for the most recent taxable year for which adjusted gross income is available, does not exceed 250 percent of the applicable poverty level. This change applies to offers-in-compromise submitted after July 1, 2019, the date of enactment.

a. Final regulations increase the user fee for processing an offer in compromise by 10 percent. T.D. 9894, User Fees for Offers in Compromise, 85 F.R. 14567 (3/13/20). The Treasury Department and the IRS have finalized, with some changes, proposed regulations that set the user fees for processing an offer in compromise. See REG-108934-16, User Fees for Offers in Compromise, 81 F.R. 70654 (10/13/16). Prior to these regulations, the general user fee for an offer in compromise was $186. However, no fee was charged for an offer in compromise based solely on doubt as to liability, or if the taxpayer was a low income taxpayer (defined as a taxpayer who has income at or below 250 percent of the federal poverty guidelines). The proposed regulations would have increased the general fee for an offer in compromise to $300, but did not propose a change for offers in compromise based on doubt as to liability or those submitted by low income taxpayers. Since the proposed regulations were issued, Congress codified the waiver of the user fee for low-income taxpayers through amendments to § 7122(c)(3) that apply to offers-in-compromise submitted after July 1, 2019. The final regulations increase the general user fee for processing an offer in compromise to $205, which is a 10-percent increase. This fee appies to offers in compromise submitted on or after April 27, 2020. The final regulations continue to waive the user fee for offers in compromise based solely on doubt as to liability. They also provide a waiver of the user fee for low income taxpayers that is consistent with amended § 7122(c)(3). The preamble to the final regulations provides a great amount of detail on how the increased user fee was determined, including the cost of the services provided.

2. The government may enforce a tax lien in federal court and sell a taxpayer's property notwithstanding the taxpayer's right to redemption under state law. Arlin Geophysical Co. v. United States, 946 F.3d 1234 (10th Cir. 1/14/20). Utah state law allows the owner of real property to redeem or purchase back foreclosed property that has a mortgage debt associated with it. *See* Utah Code Ann. § 78B-6-906(1). At common law, the property owner's equitable right of redemption ended *upon* foreclosure. In contrast, Utah law provides a statutory right to redeem *after* foreclosure. *See Layton v. Thane*, 133 F.2d 287 (10th Cir. 1943). The general policy behind redemption is to protect the property holder's right to redeem the property to insure against a foreclosure sale that is well below fair market value. Carving out a federal exception to this rule, the Tenth Circuit has held that the Utah right of redemption does not apply to properties that are sold to satisfy a taxpayer's federal tax lien. In general, under § 6321, when a taxpayer fails to pay a tax liability after receiving a notice and demand for payment, a stautory federal tax lien arises automatically by operation of law and attaches to all of the taxpayer's property. After proper notification, the government can enforce such tax liens in a federal district court. Pursuant to § 7403, the federal district court in a tax lien foreclosure action may determine the merits of all claims on the property and decree a sale of the property. According to 28 U.S.C. § 2001(a), the sale must be transacted "upon such terms and conditions as the court directs." In this case, the taxpayer, Mr. John Worthen, owed the United States more than eighteen million dollars. In connection with this liability, the IRS filed a notice of federal tax lien that encumbered fifteen properties owned by, among others, Arlin Geophysical Company (Arlin). Arlin was owned by Mr. Worthen and his wife. Arlin brought an action to quiet title to these properties. The federal district court held that Worthen was liable for the eighteen million dollars plus interest and held in favor of the government in relation to 13 of the 15 properties. Properties 14 and 15 remained at issue with the U.S. government, Fujilyte (a company owned by Worthen), and several others claiming rights to these two properties. Initially concluding that Worthen's nominee, Arlin, held title to properties 14 and 15, the federal district court in this case granted summary judgment to the government and ordered that the two properties be sold. On appeal to the Tenth Circuit, Mr. Worthen argued that neither § 7403 nor 28 U.S.C. § 2001 expressly address Mr. Worthen's redemption rights under Utah law and, therefore, he had a right of redemption in the properties. He further argued that this statutory silence supports the conclusion that Congress did not intend to usurp his state-created right of redemption and he should be able, therefore, to redeem the properties. Stated otherwise, he argued that the statutory silence indicates congressional intent that his state right of redemption should operate as the rule of decision governing the federal court. The Tenth Circuit declined to adopt Mr. Worthen's argument and instead affirmed the lower court's denial of Mr. Worthen's right to redeem the property. The Tenth Circuit held that state created rights are not the rules of decision to be applied by a federal court where the government seeks to enforce a federal tax lien. Rather, the question of whether a state-law right constitutes "property" or "rights to property" is a matter of federal law. See *Drye v. U.S.*, 528 U.S. 49, 58 (1999). According to the court, congressional silence in §§ 7403 and 2001 should be distinguished from other sections of the Internal Revenue Code and federal procedural rules that specifically provide for redemption. For example, certain statutes provide that redemption is specifically authorized within a period of time after the sale of property subject to a lien or on which the government has levied. *See* § 6337(b); 28 U.S.C. 2410(c); *see also United States v. Heasley*, 283 F.2d 422, 427 (8th Cir. 1960) (distinguishing sale of property under levy and distraint proceeding, in which redemption is specifically authorized, from property sold pursuant to judicial decree, for which Congress did not provide for a right of redemption). Thus, when Congress intends to provide redemption rights, it does so explicitly and not by silence. In the current case, the court observed, redemption is not appropriate when taxpayers have had procedural protections such as the right to an administrative appeal of a lien under § 6326 and the right to a collection due process hearing upon filing of the lien under § 6320. Statutes such as § 6331 provide redemption rights when a taxpayer is entitled to only summary administrative proceedings. In the area of federal tax liens, the court reasoned, procedures providing for the "punctilious" protection of the rights of the parties in interest—such as the requirement that interested third parties receive notice and be made parties to the action—adequately protect the interests of delinquent taxpayers. The court therefore was not persuaded that Congress's silence regarding redemption rights in § 7403 should allow delinquent taxpayers to reclaim their properties through state-provided redemption rights. Accordingly, the court held, Mr. Worthen had no right to redeem property sold pursuant to § 7403 by a federal district court.

3. The Tax Court has held that audit reconsideration followed by a conference with IRS Appeals was a prior opportunity to challenge the taxpayers' underlying tax liability and therefore they were barred by § 6330(c)(2)(B) from challenging the liability in a CDP hearing. Lander v. Commissioner, 154 T.C. No. 11 (3/12/20). While this factually complex case has a lengthy set of dates, communications and meetings between the IRS and the taxpayer, the salient elements revolve around two copies of the notice of deficiency (NOD) that were mailed by the IRS to the taxpayers (a married couple) at their last known address and also to the address of the federal prison in which the husband, Mr. Lander, was incarcerated. The dispute began in April 2009, when the Landers filed a late initial 2005 income tax return and, shortly thereafter, an amended return. In July of 2011, the IRS sent the Landers a letter notifying them of two adjustments that substantially increased their 2005 tax liability. Several weeks later, in August 2011, the Landers formally protested the adjustments and requested that the IRS send any future questions or information to the address of the federal correctional institution where Mr. Lander was incarcerated. The IRS later informed the Landers that the large adjustments resulted in additions to tax and an accuracy-related penalty. The IRS then sent the two copies of the NOD mentioend previously to the Landers' home and the prison. However, in sending the NOD to each place, the IRS examiner recorded the two certified mail numbers improperly. He recorded the number for each parcel on the documentation in the IRS file for the other parcel. Regardless, each parcel was recorded by the U.S. Postal Service as having reached its destination. However, because Mr. Lander had been moved to another correctional facility and because Mrs. Lander had moved out of their home, the Landers did not receive either NOD. In July 2012, the IRS sent a notice and demand for payment. The taxpayers asked for reexamnation of their tax liability. The Examination Division reaffirmed the adjustments to their tax liability, following which the taxpayers requested and received a confierence with the IRS Appeals Office, which abated a substantial amount of the originally assessed tax but continued to demand a portion of the originally assessed amounts. In January 2015 the IRS sent the taxpayers a Notice of Federal Tax Lien Filing (NFTLF).

The taxpayers timely requested a collection due process (CDP) hearing and maintained their assertion that the IRS's underlying assessment of tax was invalid because they did not receive either copy of the original NOD. Following the CDP hearing, the IRS Appeals Office concluded that the NOD had been properly mailed to the last known address of the taxpayers and sustained the NFTLF.

Tax Court's Analysis. The Tax Court addressed whether the IRS Appeals Office erred in determining that the Landers were barred from challenging the assessed tax liability in the CDP hearing. The Tax Court narrowed the question to whether the NOD was properly mailed to the taxpayers at their last known address. Section 6330(c)(2)(B) permits a taxpayer to challenge the existence or amount of the taxpayer's underlying tax liability in a CDP hearing only "if the person did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability." Accepting the testimony of the IRS's witness, the court agreed with the IRS that it had properly mailed the NOD to the taxpayers' last known address in 2011. The court did not accept the Landers' argument that the discrepancies in the recording of the certified mail numbers of each parcel was not sufficient to undermine the evidence otherwise indicating that the NOD was properly mailed. The court also declined to accept the Landers' argument that they were not given an opportunity to dispute their tax liability. In reaching this conclusion, the Tax Court relied on its decision in *Lewis v. Commissioner*, in which the court reasoned:

> While it is possible to interpret section 6330(c)(2)(B) to mean that every taxpayer is entitled to one opportunity for a precollection judicial review of an underlying liability, we find it unlikely that this was Congress's intent. As we see it, if Congress had intended to preclude only those taxpayers who previously enjoyed the opportunity for judicial review of the underlying liability from raising the underlying liability again in a collection review proceeding, the statute would have been drafted to clearly so provide. The fact that Congress chose not to use such explicit language leads us to believe that Congress also intended to preclude taxpayers who were previously afforded a conference with the Appeals Office from raising the underlying liabilities again in a collection review hearing and before this Court. See Lewis v. Commissioner, 128 T.C. at 60-61.

Consistent with this reasoning, the Tax Court turned to whether the Landers were afforded a conference with the IRS Appeals Office and whether they had an opportunity to dispute their tax liability. The court found that the Landers had received a post-assessment conference in the form of the audit reconsideration process. The reconsideration process provided for an independent review of the Landers' underlying tax liability by the IRS Appeals Office, which resulted in significantly reducing their tax liability. Under these circumstances, the court held that the Landers had a prior opportunity to dispute their tax liability within the meaning of § 6330(c)(2)(B) and that they were therefore barred from challenging the amount of their underlying liability.

G. Innocent Spouse

H. Miscellaneous

1. The Tenth Circuit stirs the previously muddied water on whether a late-filed return is a "return" that will permit tax debt to be discharged in bankruptcy proceedings. In re Mallo, 774 F.3d 1313 (10th Cir. 12/29/14), *cert denied*, 135 S. Ct. 2889 (6/29/15). In an opinion by Judge McHugh, the Tenth Circuit held, with respect to taxpayers in two consolidated appeals, that a late return filed after the IRS had assessed tax for the year in question was not a "return" within the meaning of 11 U.S.C. § 523(a) and, consequently, the taxpayers' federal tax liabilities were not dischargeable in bankruptcy. The facts in each appeal were substantially the same. The taxpayers failed to file returns for the years 2000 and 2001. The IRS issued notices of deficiency, which the taxpayers did not challenge, and assessed tax for those years. The taxpayers subsequently filed returns, based on which the IRS partially abated the tax liabilities. The taxpayers then received general discharge orders in chapter 7 bankruptcy proceedings and filed adversary proceedings against the IRS seeking a determination that their income tax liabilities for 2000 and 2001 had been discharged. Section 523(a)(1) of the Bankruptcy Code excludes from discharge any debt for a tax or customs duty:

(B) with respect to which a return, or equivalent report or notice, if required—

(i) was not filed or given; or

(ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of filing of the petition;

An unnumbered paragraph at the end of Bankruptcy Code § 523(a), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, provides that, for purposes of § 523(a):

> the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared under section 6020(a) of the Internal Revenue Code … but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code ….

The court examined a line of conflicting cases in which the courts had applied a four-factor test, commonly known as the *Beard* test (*Beard v. Commissioner*, 793 F.2d 139 (6th Cir. 1986)), to determine whether a late-filed return constitutes a "return" for purposes of 11 U.S.C. § 523(a) and concluded that it did not need to resolve that issue. Instead, the court concluded that, unless it is prepared by the IRS with the assistance of the taxpayer under § 6020(a), a late return is not a "return" because it does not satisfy "the requirements of applicable nonbankruptcy law (including applicable filing requirements)" within the meaning of the language added to the statute in 2005.

- In reaching its conclusion, the Tenth Circuit agreed with the analysis of the Fifth Circuit in *In re McCoy*, 666 F.3d 924 (5th Cir. 2012), in which the Fifth Circuit concluded that a late-filed Mississippi state tax return was not a "return" within the meaning of 11 U.S.C. § 523(a).

- The Tenth Circuit's interpretation of 11 U.S.C. § 523(a) is contrary to the IRS's interpretation, which the IRS made clear to the court during the appeal. The IRS's interpretation, reflected in Chief Counsel Notice CC-2010-016 (9/2/10), is that "section 523(a) does not provide that every tax for which a return was filed late is nondischargeable." However, according to the Chief Counsel Notice, a debt for tax assessed before the late return is filed (as in the situations before the Tenth Circuit in *In re Mallo*) "is not dischargeable because a debt assessed prior to the filing of a Form 1040 is a debt for which is return was not 'filed' within the meaning of section 523(a)(1)(B)(i)."

a. The First Circuit aligns itself with the Fifth and Tenth Circuits and applies the same analysis to a late-filed Massachusetts state income tax return. In re Fahey, 779 F.3d 1 (1st Cir. 2/18/15). In an opinion by Judge Kayatta, the First Circuit aligned itself with the Fifth and Tenth Circuits and concluded that a late-filed Massachusetts state income tax return was not a "return" within the meaning of 11 U.S.C. § 523(a). In a lengthy dissenting opinion, Judge Thompson argued that the majority's conclusion was inconsistent with both the language of and policy underlying the statute: "The majority, ignoring blatant textual ambiguities and judicial precedent, instead opts to create a per se restriction that is contrary to the goal of our bankruptcy system to provide, as the former President put it in 2005, 'fairness and compassion' to 'those who need it most.'"

b. A Bankruptcy Appellate Panel in the Ninth Circuit disagrees with the First, Fifth, and Tenth Circuits. The Ninth Circuit now might have an opportunity to weigh in. In re Martin, 542 B.R. 479 (B.A.P. 9th Cir. 12/17/15). In an opinion by Judge Kurtz, a Bankruptcy Appellate Panel in the Ninth Circuit disagreed with what it called the "literal construction" by the First, Fifth and Ninth Circuits of the definition of the term "return" in Bankruptcy Code § 523(a). The court emphasized that the meaning of the language in the unnumbered paragraph at the end of Bankruptcy Code § 523(a), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which provides that "the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements)," must be determined by taking into account the context of the surrounding words and also the context of the larger statutory scheme. Taking this context into account, the court reasoned, leads to the conclusion that the statutory language does not dictate that a late-filed return automatically renders the taxpayer's income tax liability non-dischargeable. "Why Congress would want to treat a taxpayer who files a tax return a month or a week or even a day late—possibly for reasons beyond his or her control—so much more harshly than a taxpayer who never files a tax return on his or her own behalf [and instead relies on the IRS to prepare it pursuant to § 6020(a)] is a mystery that literal construction adherents never adequately explain." The court also rejected the IRS's interpretation, reflected in Chief Counsel Notice CC-2010-016 (9/2/10) that, although not every tax for which a return is filed late is nondischargeable, a debt for tax assessed before the late return is filed (as in the situation before the court) is not dischargeable because the tax debt is established by the assessment and therefore arises before the return was filed. Instead, the court concluded that binding Ninth Circuit authority predating the 2005 amendments to Bankruptcy Code § 523(a) requires applying the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) to determine whether a late-filed return constitutes a "return" for purposes of 11 U.S.C. § 523(a). The court concluded that the Bankruptcy Court, which had held that the taxpayers' late-filed returns were "returns" within the meaning of the statute, had relied on a version of the *Beard* test that did not reflect the correct legal standard. Accordingly, the court remanded to the Bankruptcy Court for further consideration.

c. The Eleventh Circuit declines to decide whether a late-filed return always renders a tax debt nondischargeable in bankruptcy. In re Justice, 817 F.3d 738 (11th Cir. 3/30/16). In an opinion by Judge Anderson, the Eleventh Circuit declined to adopt what it called the "one-day-late" rule embraced by the First, Fifth and Tenth Circuits because it concluded that doing so was unnecessary to reach the conclusion that the taxpayer's federal income tax liability was nondischargeable in bankruptcy. The taxpayer filed his federal income tax returns for four tax years after the IRS had assessed tax for those years and between three and six years late. The court concluded that it need not adopt the approach of the First, Fifth and Tenth Circuits because, even if a late-filed return can sometimes qualify as a return for purposes of Bankruptcy Code § 523(a), a return must satisfy the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) in order to constitute a return for this purpose, and the taxpayer's returns failed to satisfy this test. One of the four factors of the *Beard* test is that there must be an honest and reasonable attempt to satisfy the requirements of the tax law. The Eleventh Circuit joined the majority of the other circuits in concluding that delinquency in filing a tax return is relevant to whether the taxpayer made such an honest and reasonable attempt. "Failure to file a timely return, at least without a legitimate excuse or explanation, evinces the lack of a reasonable effort to comply with the law." The taxpayer in this case, the court stated, filed his returns many years late, did so only after the IRS had issued notices of deficiency and assessed his tax liability, and offered no justification for his late filing. Accordingly, the court held, he had not filed a "return" for purposes of Bankruptcy Code § 523(a) and his tax debt was therefore nondischargeable.

d. The Ninth Circuit holds that a taxpayer's tax debt cannot be discharged in bankruptcy without weighing in on the issue whether a late-filed return always renders a tax debt nondischargeable. In re Smith, 828 F.3d 1094 (9th Cir. 7/13/16). In an opinion by Judge Christen, the Ninth Circuit held that the tax liability of the taxpayer, who filed his federal income tax return seven years after it was due and three years after the IRS had assessed the tax, was not dischargeable in bankruptcy. The government did not assert the "one-day-late" rule embraced by the First, Fifth and Tenth Circuits. Accordingly, the Ninth Circuit looked to its prior decision in *In re Hatton*, 220 F.3d 1057 (9th Cir. 2000), issued prior to the 2005 amendments to the Bankruptcy Code on which the First, Fifth and Tenth Circuits relied. In *In re Hatton*, the Ninth Circuit had adopted the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) to determine whether the taxpayer had filed a "return" for purposes of Bankruptcy Code § 523(a). The fourth factor of the *Beard* test is that there must be an honest and reasonable attempt to satisfy the requirements of the tax law. The Ninth Circuit concluded that the taxpayer had not made such an attempt:

> Here, Smith failed to make a tax filing until seven years after his return was due and three years after the IRS went to the trouble of calculating a deficiency and issuing an assessment. Under these circumstances, Smith's "belated acceptance of responsibility" was not a reasonable attempt to comply with the tax code.

The court noted that other circuits similarly had held that post-assessment filings of returns were not honest and reasonable attempts to satisfy the requirements of the tax law, but refrained from deciding whether any post-assessment filing could be treated as such an honest and reasonable attempt.

e. The Third Circuit also declines to consider whether a late-filed return always renders a tax debt nondischargeable and instead applies the *Beard* test. Giacchi v. United States, 856 F.3d 244 (3d Cir. 5/5/17). In an opinion by Judge Roth, the Third Circuit held that the tax liability of the taxpayer, who filed his federal income tax returns for 2000, 2001, and 2002 after the IRS had assessed tax for those years, was not dischargeable in bankruptcy. The court declined to consider whether the "one-day-late" rule embraced by the First, Fifth and Tenth Circuits is correct. Instead, the court applied the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) to determine whether the taxpayer had filed a "return" for purposes of Bankruptcy Code § 523(a). The fourth factor of the *Beard* test is that there must be an honest and reasonable attempt to satisfy the requirements of the tax law. The court stated:

> 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. … Once the 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.

f. The Eleventh Circuit has rejected the one-day late approach to determining whether a late-filed return renders a tax debt nondischargeable in bankruptcy. In re Shek, 947 F.3d 770 (11th Cir. 1/23/20). In a very thorough opinion by Judge Anderson, the Eleventh Circuit has held that a tax debt reflected on a late-filed Massachusetts tax return was discharged in bankruptcy. In reaching this conclusion, the court rejected the "one-day-late" rule embraced by the First, Fifth and Tenth Circuits. The taxpayer filed his 2008 Massachusetts income tax return seven months late. The return reflected a tax liability of $11,489. Six years later, he filed for chapter 7 bankruptcy in Florida and received an order of discharge in January 2016. When the Massachusetts Department of Revenue subsequently sought to collect the tax debt, the taxpayer filed a motion to reopen his bankruptcy case to determine whether his tax debt debt had been discharged. The Bankruptcy Court held that his tax debt had been discharged. In affirming this conclusion, the Eleventh Circuit focused on the definition of the term "return" in § 523(a) of the Bankruptcy Code, added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which provides that, for purposes of § 523(a):

> the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared under section 6020(a) of the Internal Revenue Code … but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code ….

The court emphasized that canons of statutory construction dictate the need to give effect to every word of a statute when possible and that the term "applicable filing requirements" must mean something different than all filing requirements. Further, the court reasoned, adopting the "one-day-late" approach and holding that the tax liability reflected on every late-filed return is not dischargeable would render a near nullity the language of § 523(a)(1)(B)(ii) of the Bankruptcy Code, which contemplates that the tax liability on a late-filed return can be discharged as long as the late return is not filed within the two-year period preceding the filing of the bankruptcy petition. The court also rejected the Department of Revenue's argument that the taxpayer's return did not constitute a return under Massachusetts law (which the court viewed as included among "the requirements of applicable nonbankruptcy law"). After rejecting the one-day late approach, the court held that the taxpayer's return was a "return" whether the relevant test is the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) or instead the definition of a return under Massachusetts law. Accordingly, the court held, the taxpayer's tax liability had been discharged.

2. The IRS has announced that individuals will be able to e-file amended returns on Form 1040-X for 2019. IR-2020-107 (5/28/20). Individuals who wish to amend a federal income tax return by filing Form 1040-X currently must mail the form to the IRS. The IRS has announced that, beginning sometime during the summer of 2020, individuals will be able to e-file Form 1040-X using available software products to amend Forms 1040 or 1040-SR for 2019. Whether the ability to e-file amended returns will be expanded to other years is not entirely clear. The announcement states that "[a]dditional enhancements are planned for the future." Taxpayers still will have the option to mail a paper version of Form 1040-X.

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

A. Enacted

1. A Families Second Coronavirus Response Act just wouldn't do. Congress has enacted the Families First Coronavirus Response Act. The Families First Coronavirus Response Act, Pub. L. No. 116-127, was signed by the Presdient on March 18, 2020. Among other features, the legislation provides businesses with tax credits to cover certain costs of providing employees with required paid sick leave and expanded family and medical leave, for reasons related to COVID-19, from April 1 through December 31, 2020.

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. Taxpayer restores money-pit mansion to its former glory, but due to taxpayer's failure to rent or hold out for rental, gets "hammered" by capital loss. Keefe v. Commissioner, T.C. Memo 2018-28 (3/15/18). These married taxpayers, neither of whom was an architect or contractor, acquired and restored Wrentham House, a historic mansion in Newport, Rhode Island. From May of 2000 until May of 2008 the taxpayers spent approximately $10 million repairing and restoring the mansion with the goal of turning it into a luxury vacation rental property. Notwithstanding taxpayers' $10 million investment in the mansion, structural and other problems prevented the property from being marketable as a rental property until June of 2008. At that time, of course, the "Great Recession" was in full swing, and there was virtually no market and no prospect for luxury rentals. Consequently, the mansion was never rented or even seriously marketed for rental, and in August of 2009, the mansion was sold in a short sale for approximately $6 million. The taxpayers claimed that the mansion was § 1231 property used in a trade or business thereby entitling them to ordinary loss treatment. The Service contended that the mansion was not used in a trade or business but instead was a capital asset, so the loss on the short sale was a capital loss subject to the $3,000 per year limitation of § 1211(b). The Tax Court (Chief Judge Marvel) held for the Service. Citing *Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953) because the case would be appealable to the Second Circuit Court of Appeals, Judge Marvel explained that the taxpayers failed to show that their alleged rental activities were "sufficient, continuous, and substantial enough to constitute a trade or business with respect to rental of the property" (emphasis added). Instead, Judge Marvel ruled that the mansion was property "held for the production of income, but not used in a trade or business of the taxpayer." Reg. § 1.1221-1(b). Accordingly, § 1231 did not apply to the mansion, so the mansion was a capital asset subject to the capital loss limitation of § 1211(b). The court also upheld the Service's imposition of accuracy-related penalties.

a. And the Second Circuit agrees. Keefe v. Commissioner, 2020 WL 4032469 (2d Cir. 7/17/20), *aff'g* T.C. Memo 2018-28 (3/15/18). In a relatively brief opinion, the Second Circuit affirmed the decision of the Tax Court. Writing for the Second Circuit, Judge Walker agreed with Judge Marvel that the taxpayer's activities with respect to the mansion did not rise to the level of a trade or business. Therefore, the mansion was a capital asset, not a § 1231 asset, and the taxpayers thus suffered a capital loss, not an ordinary loss, upon the short sale of the mansion. Nevertheless, Judge Walker quibbled a bit with Judge Marvel's analysis. Specifically, Judge Walker wrote that the standard applied by Judge Marvel was more stringent than required by prior Second Circuit decisions. Specifically, to determine trade or business status with respect to real estate rental activities, Judge Marvel of the Tax Court examined whether the taxpayers' activities concerning the mansion were sufficiently "continuous, regular, and substantial." Judge Marvel's opinion stated, "The Court of Appeals for the Second Circuit requires that taxpayers be engaged in continuous, regular, and substantial activity in relation to the management of the property to support a conclusion that the property was used in a trade or business and was not a capital asset." *See* T.C. Memo 2018-28 at 16-17. In Judge Walker's view, however, Second Circuit precedent only requires a taxpayer's real estate rental activities to be "regular and continuous" to support a trade or business finding. Judge Walker explained that the Second Circuit has never expressly added the word "substantial" to the "continuous and regular" standard for testing trade or business status with respect to real estate rental activities. *See* 2020 WL 4032469 at footnote 22. Regardless, Judge Walker affirmed Judge Marvel's holding because the taxpayers' activities with respect to the mansion were not "regular and continuous" enough to justify a trade or business finding. Judge Walker also upheld Judge Marvel's decision to impose accuracy-related penalties.

B. Interest, Dividends, and Other Current Income

C. Profit-Seeking Individual Deductions

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

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

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

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

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

b. IRS issues proposed regulations clarifying that certain deductions allowed to an estate or non-grantor trust are not miscellaneous itemized deductions. REG-113295-18, Effect of Section 67(g) on Trusts and Estates, 85 F.R. 27693 (5/11/20). Based upon comments received pursuant to Notice 2018-61, the IRS has issued proposed regulations clarifying that deductions described in § 67(e)(1) and (2) are not miscellaneous itemized deductions. The proposed regulations would amend Reg. § 1.67-4 to clarify that § 67(g) does not deny deductions described under § 67(e)(1) and (2) for estates and nongrantor trusts. These deductions generally include administration expenses of the estate or trust which would not have been incurred if the property were not held in such trust or estate and the personal exemption deduction of an estate or non-grantor trust. Such deductions are allowable in arriving at adjusted gross income (AGI) and are not considered miscellaneous itemized deductions under § 67(b). The proposed regulations specifically do not address whether such deductions will continue to be deductible for purposes of the alternative minimum tax.

The proposed regulations also provide guidance under § 642(h) in relation to net operating loss and capital loss carryovers under subsection (h)(1) and the excess deduction under (h)(2). They implement a more specific method aimed at preserving the tax character of three categories of expenses. Thus, fiduciaries are required to separate deductions into at least the three following categories: (1) deductions allowed in arriving at adjusted gross income, (2) non-miscellaneous itemized deductions, and (3) miscellaneous itemized deductions. Under this regime, each deduction comprising the § 642(h)(2) excess deduction retains its separate character which passes through to beneficiaries on termination of the estate or trust. Separately stating these categories of expenses facilitates proper reporting by beneficiaries.

The proposed regulations adopt the principles used under Reg. § 1.652(b)-3 in allocating items of deduction among the classes of income in the final year of a trust or estate for purposes of determining the character and amount of the excess deductions under section 642(h)(2). In general, Reg. § 1.652(b)-3 provides that deductions attributable to a particular class of income retain their character. Any remaining deductions that are not directly attributable to a specific class of income are allocated to any item of income (including capital gains) with a portion allocated to any tax-exempt income. See Reg. § 1.652(b)-3(b), (d). The character and amount of each deduction remaining represents the excess deductions available to the beneficiaries. The proposed regulations provide a useful example for determining the character of excess deductions.

D. Section 121

E. Section 1031

F. Section 1033

G. Section 1035

H. Miscellaneous

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. There are no adverse tax consequences for employees if they forgo their vacation, sick, or personal leave in exchange for the employer's contributions to charitable organizations providing disaster relief for those affected by the COVID-19 pandemic. Notice 2020-46, 2020-27 I.R.B. 7 (6/11/20). In this notice, the IRS has provided guidance on the tax treatment of cash payments that employers make pursuant to leave-based donation programs for the relief of victims of the COVID-19 pandemic in all 50 states, the District of Columbia, and certain U.S. territories (affected geograpic areas). Under leave-based donation programs, employees can elect to forgo vacation, sick, or personal leave in exchange for cash payments that the employer makes to charitable organizations described in § 170(c). The notices provide that the IRS will not assert that: (1) cash payments an employer makes before January 1, 2021, to charitable organizations described in § 170(c) for the relief of victims of the COVID-19 pandemic in affected geograpic areas in exchange for vacation, sick, or personal leave that its employees elect to forgo constitute gross income or wages of the employees; or (2) the opportunity to make such an election results in constructive receipt of gross income or wages for employees, Employers are permitted to deduct these cash payments either under the rules of § 170 as a charitable contribution or under the rules of § 162 as a business expense if the employer otherwise meets the requirements of either provision. Employees who make the election cannot claim a charitable contribution deduction under § 170 for the value of the forgone leave. The employer need not include cash payments made pursuant to the program in Box 1, 3 (if applicable), or 5 of the employee's Form W-2.

B. Qualified Deferred Compensation Plans

1. Congress has made access to retirement plan funds easier for those affected by COVID-19. The CARES Act, § 2202, provides special rules that apply to distributions from qualified employer plans and IRAs and to loans from qualified employer plans for those affected by the Coronavirus.

Coronavirus-related distributions. Section 2202(a) of the legislation provides four special rules for "coronavirus-related distributions." **First**, the legislation provides that coronavirus-related distributions up to an aggregate amount of $100,000 for each year are not subject to the normal 10-percent additional tax of § 72(t) that applies to distributions to a taxpayer who has not reached age 59-1/2. **Second**, the legislation provides that, unless the taxpayer elects otherwise, any income resulting from a coronavirus-related distribution is reported ratably over the three-year period beginning with the year of the distribution. **Third**, the legislation permits the recipient of a coronavirus-related distribution to contribute up to the amount of the distribution to a qualified employer plan or IRA that would be eligible to receive a rollover contribution of the distribution. The contribution need not be made to the same plan from which the distribution was received, and must be made during the three-year period beginning on the day after the date on which the distribution was received. If contributed within the required three-year period, the distribution and contribution are treated as made in a direct trustee-to-trustee transfer within 60 days of the distribution. The apparent intent of this rule is to permit the taxpayer to exclude the distribution from gross income to the extent it is recontributed within the required period. Because the recontribution might take place in a later tax year than the distribution, presumably a taxpayer would include the distribution in gross income in the year received and then file an amended return for the distribution year upon making the recontribution. **Fourth**, coronavirus-related distributions are not treated as eligible rollover distributions for purposes of the withholding rules, and therefore are not subject to the normal 20 percent withholding that applies to eligible rollover distributions under § 3405(c). A coronavirus-related distribution is defined as any distribution from an eligible retirement plan as defined in § 402(c)(8)(B) (which includes qualified employer plans and IRAs) that was made: (1) on or after January 1, 2020, and before December 31, 2020, (2) to an individual who is diagnosed (or whose spouse or dependent is diagnosed) with the virus under an approved test or

> who experiences adverse financial consequences as a result of being quarantined, being furloughed or laid off or having work hours reduced due to such virus or disease, being unable to work due to lack of child care due to such virus or disease, closing or reducing hours of a business owned or operated by the individual due to such virus or disease,

or other factors as determined by the Secretary of the Treasury (or the Secretary's delegate).

Loans. For qualified individuals, section 2202(b) of the legislation increases the limit on loans from qualified employer plans and permits repayment over a longer period of time. Normally, under § 72(p), a loan from a qualified employer plan is treated as a distribution unless it meets certain requirements. One requirement is that the loan must not exceed the lesser of (1) $50,000 or (2) the greater of one-half of the present value of the employee's nonforfeitable accrued benefit or $10,000. A second requirement is that the loan must be repaid within five years. In the case of a loan made to a "qualified individual" during the period from March 27, 2020 (the date of enactment) through December 31, 2020), the legislation increases the limit on loans to the lesser of (1) $100,000 or (2) the greater of *all* of the present value of the employee's nonforfeitable accrued benefit or $10,000. The legislation also provides that, if a qualified individual has an outstanding plan loan on or after March 27, 2020 (the date of enactment) with a due date for any repayment occurring during the period beginning on March 27, 2020 (the date of enactment) and ending on December 31, 2020, then the due date is delayed for one year. If an individual takes advantage of this delay, then any subsequent repayments are adjusted to reflect the delay in payment and interest accruing during the delay. This appears to require reamortization of the loan. A *qualified individual* is defined as an individual who would be eligible for the distribution rules described above.

a. The IRS has provided guidance on the CARES Act provisions that facilitate access to retirement funds by those affected by COVID-19. Notice 2020-50, 2020-28 I.R.B. 35 (6/22/20). This notice provides guidance regarding the special rules enacted as part of the CARES Act, § 2202, that apply to distributions from qualified employer plans and IRAs and to loans from qualified employer plans for those affected by the Coronavirus.

Distributions qualifying as c*oronavirus-related distributions*. Section 1 of the notice provides guidance in three areas relevant to determining whether a distribution is a "coronavirus-related distribution" as defined in § 2202(a)(4)(A) of the CARES Act. **First**, the notice provides guidance on individuals eligible to receive coronavirus-related distributions, whom the notice describes as "qualified individuals." Pursuant to the discretion granted by the statute, the notice expands the category of qualified individuals beyond the individuals expressly described in the statute. According to the notice, the category of qualified individuals includes those who experience adverse financial consequences as a result of the causes listed in the statute (such as being quarantined, furloughed or laid off or having work hours reduced due to the virus), and also those who experience adverse financial consequences as a result of (1) "the individual having a reduction in pay (or self-employment income) due to COVID-19 or having a job offer rescinded or start date for a job delayed due to COVID-19," (2) the individual's spouse or a member of the individual's household experiencing any of the same statutory or non-statutory situations (i.e., being furloughed, laid off, having a start date for a job delayed etc.), and (3) "closing or reducing hours of a business owned or operated by the individual's spouse or a member of the individual's household due to COVID-19." For this purpose, a member of the individual's household is someone who shares the individual's principal residence. **Second**, the notice provides guidance on the distributions that qualify as coronavirus-related distributions. According to the notice, there is no requirement that qualified individuals show that distributions were used for purposes related to COVID-19 in order to qualify as coronavirus-related distributions. Thus, "coronavirus-related distributions are permitted without regard to the qualified individual's need for funds, and the amount of the distribution is not required to correspond to the extent of the adverse financial consequences experienced by the qualified individual." The notice further provides that, with only limited exceptions (specified in the notice), a qualified individual can designate *any* distribution as a coronavirus-related distribution up to the statutory maximum of $100,000. The distributions that an individual can designate as coronavirus-related distributions therefore include any periodic payments, any amounts that would have been required minimum distributions (RMDs) in 2020 were it not for the suspension of RMDs by the CARES Act, any distributions received as a beneficiary, and any reduction or offset of a qualified individual's account balance in order to repay a plan loan. If designated as coronavirus-related distributions, all of these distributions can be included in income ratably over three years. (As described below, however, not all of these distributions are eligible for recontribution and treatment as a tax-free rollover.) The notice recognizes that "a qualified individual's designation of a coronavirus-related distribution may be different from the employer retirement plan's treatment of the distribution" for a variety of reasons, such as a distribution occurring before the effective date of a plan amendment providing for coronavirus-related distributions or the existence of multiple retirement accounts from which the individual withdraws more than $100,000 in the aggregate. **Third**, the notice provides guidance on which coronavirus-related distributions can be recontributed and treated as tax-free rollovers. According to the notice, "only a coronavirus-related distribution that is eligible for tax-free rollover treatment under § 402(c), 403(a)(4), 403(b)(8), 408(d)(3), or 457(e)(16) is permitted to be recontributed to an eligible retirement plan." Such recontributions are treated as having been made in a trustee-to-trustee transfer to the eligible retirement plan. A coronavirus-related distribution paid to a qualified individual as a beneficiary of an employee or IRA owner (other than the surviving spouse of the employee or IRA owner) cannot be recontributed. Although distributions from an employer retirement plan made on account of hardship are not eligible for recontribution and treatment of tax-free rollovers, a distribution that meets the definition of a coronavirus-related distribution is not treated as made on account of hardship for purposes of the notice.

Tax treatment of receiving and recontributing coronavirus-related distributions. Section 4 of the notice provides guidance on the tax treatment of a qualified individual receiving and recontributing coronavirus-related distributions. The notice provides that a qualified individual who designates a distribution as a coronavirus-related distribution includes the distribution in income ratably over a three-year period beginning in the year in which the distribution occurs unless the individual elects to include the entire amount of the taxable portion of the distribution in income in the year of the distribution. According to the notice, an individual cannot elect out of the three-year ratable income inclusion after having timely filed the individual's federal income tax return for the year of the distribution. Thus, the election out cannot be made on an amended tax return. Further, an individual must treat all coronavirus-related distributions consistently by either including all of them in income ratably over three years or including all of them in income in the year in which the distributions occurred. An individual must report coronavirus-related distributions on the individual's federal income tax return (if required to be filed) and on Form 8915-E, Qualified 2020 Disaster Retirement Plan Distributions and Repayments. On Form 8915-E, which is expected to be available before the end of 2020, an individual will indicate whether he or she elects out of the three-year ratable income inclusion rule. An individual also will report recontributions of coronavirus-related distributions on Form 8915-E. The notice provides several examples that illustrate how an individual should report recontributions of coronavirus-related distributions when the individual has reported income from the distributions both ratably over three years and in a single year (the year of distribution). Generally, if an individual includes a coronavirus-related distribution in income entirely in the year of distribution and recontributes some or all of the distribution within the three-year period beginning on the day after the distribution, the individual will file an amended tax return for the year of distribution to reduce the portion of the distribution included in income and also will file a revised Form 8915-E. If an individual instead reports the income from a coronavirus-related distribution ratably over three years, then the individual will reduce the income reported on the return for the year in which the recontribution is made. The notice permits an individual using the three-year ratable inclusion method who recontributes more than the amount reportable as income on the return for the year of recontribution to carry the excess recontribution back or forward to reduce income from the coronavirus-related distribution in other years; carrying such excess recontributions back would require filing an amended return. A qualified individual who dies before including the full taxable amount of the coronavirus-related distribution in gross income must include the remainder of the distribution in gross income for the taxable year that includes the individual's death. If an individual is receiving substantially equal periodic payments from an eligible retirement plan and receives a coronavirus-related distribution, the receipt of the coronavirus-related distribution will not be treated as a change in substantially equal payments as described in § 72(t)(4).

Retirement plans and IRAs making or receiving recontributions of coronavirus-related distributions. Section 2 of the notice provides guidance for employer retirement plans making coronavirus-related distributions on topics such as the plan's option to treat distributions as coronavirus-related distributions; the dates by which any plan amendments must be made; the fact that the normal requirements of offering a direct rollover, withholding 20 percent of the distribution, and providing a § 402(f) notice do not apply to coronavirus-related distributions; and the ability of plan administrators to rely on an individual's certification that the individual is a qualified individual in determining whether a distribution is a coronavirus-related distribution unless the administrator has actual knowledge to the contrary. Section 3 of the notice provides guidance for employer retirement plans and IRAs on the required tax reporting for coronavirus-related distributions and on accepting recontributions of such distributions. The notice provides that coronavirus-related distributions should be reported on Form 1099-R with either distribution code 2 (early distribution, exception applies) or distribution code 1 (early distribution, no known exception) in box 7 of Form 1099-R.

Plan loans. Section 5 of the notice provides guidance on the changes made by the CARES Act that affect loans from qualified employer plans, i.e., the legislation's increase in the limit on such loans and its extension of the period of repayment for certain outstanding loans. The notice makes clear that employer plans may, but are not required to, offer this permissible delay in loan repayment. The notice provides a safe harbor that qualified employer plans can use to satisfy the requirements of § 72(p) (i.e., to avoid having a plan loan treated as a distribution) and provides an example that illustrates the safe harbor and the reamortization of a plan loan for which repayment is delayed.

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

D. Individual Retirement Accounts

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

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

D. Deductions and Credits for Personal Expenses

1. Although the IRS treats Medicaid waiver payments as excludable from gross income, such payments are earned income for purposes of the earned income credit and the child tax credit, says the Tax Court. Feigh v. Commissioner, 152 T.C. 267 (5/15/19). Medicaid waiver payments are payments to individual care providers for the care of eligible individuals under a state Medicaid Home and Community-Based Services waiver program described in section 1915(c) of the Social Security Act. Generally, these payments are made by a state that has obtained a Medicaid waiver that allows the state to include in the state's Medicaid program the cost of home or community-based services (other than room and board) provided to individuals who otherwise would require care in a hospital, nursing facility, or intermediate care facility. In Notice 2014-7, 2014-4 I.R.B. 445, the IRS concluded that Medicaid waiver payments qualify as "difficulty of care payments" within the meaning of § 131(c) and therefore can be excluded from the recipient's gross income under § 131(a), which excludes amounts received by a foster care provider as qualified foster care payments. Generally, difficulty of care payments are compensation for providing additional care to a qualified foster individual that is required by reason of the individual's physical, mental, or emotional handicap and that is provided in the home of the foster care provider. In this case, the taxpayers, a married couple, received Medicaid waiver payments in 2015 in the amount of $7,353, which were reflected on Form W-2, for the care of their disabled adult children. The taxpayers reported this amount as wages on their 2015 return but excluded the payments from gross income. They received no other income during 2015 that would qualify as earned income. The taxpayers claimed an earned income credit of $3,319 and an additional child tax credit of $653. The IRS asserted that the Medicaid waiver payment was not earned income and therefore disallowed the taxpayers' earned income credit and child tax credit. The Tax Court (Judge Goeke) held that the Medicaid waiver payments in the amount of $7,353 did qualify as earned income for purposes of both the earned income credit and the additional child tax credit. For this purpose, section 32(c)(2)(A)(i) defines "earned income" as

> wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income for the taxable year.

The court reasoned that, even though the taxpayers did not *include* in gross income the Medicaid waiver payments they received, the payments were *includible* in gross income. The court engaged in a lengthy analysis of Notice 2014-7, in which the IRS had concluded that such payments could be excluded from gross income under § 131(a) and determined that the notice was entitled to so-called *Skidmore* deference (*Skidmore v. Swift & Co.*, 323 U.S. 134 (1944)), under which a government agency's interpretation is accorded respect befitting "the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those facts which give it the power to persuade, if lacking power to control." The Tax Court concluded that Notice 2014-7 was "entitled to little, if any, deference." In other words, the court concluded that the IRS got it wrong when it determined that the taxpayers' Medicaid waiver payments were excludable from gross income. Based on its analysis, the court accepted the taxpayers' argument that the IRS could not reach a result contrary to the Code by reclassifying the taxpayers' earned income as unearned for purposes of determining eligibility for the tax credits in question. The IRS argued that no statutory provision demonstrated that Congress intended to allow a double benefit, i.e., both an exclusion of the Medicaid waiver payment from gross income and eligibility for the earned income credit and child tax credit. The court responded: "Respondent's argument, however, misses that he, not Congress, has provided petitioners with a double tax benefit."

- The taxpayers were represented by the Low Income Taxpayer Clinic at the University of Minnesota Law School.

a. The IRS has acquiesced in the result in *Feigh* and will not argue that Medicaid waiver payments that are excluded from income under Notice 2014-7 but otherwise meet the definition of earned income are not earned income for determining eligibility for the earned income credit and additional child tax credit. A.O.D. 2020-2, 2020-14 I.R.B. 558 (3/30/20). In *Feigh v. Commissioner*, 152 T.C. 267 (5/15/19), the taxpayers, a married couple, received Medicaid waiver payments of $7,353, which were reflected on Form W-2, for care they provided to their disabled adult children. The taxpayers excluded the payments from their gross income pursuant to Notice 2014-7, 2014-4 I.R.B. 445, in which the IRS concluded that Medicaid waiver payments qualify as "difficulty of care payments" within the meaning of § 131(c) and therefore can be excluded from the recipient's gross income under § 131(a), which excludes amounts received by a foster care provider as qualified foster care payments. Nevertheless, the taxpayers claimed an earned income credit of $3,319 and an additional child tax credit of $653. The Tax Court rejected the IRS's argument that the payments, which were excluded from the taxpayer's income, did not meet the definition of earned income and that the taxpayers therefore were ineligible for the earned income credit and the additional child tax credit. The Tax Court reasoned that, even though the taxpayers did not *include* in gross income the Medicaid waiver payments they received, the payments were *includible* in gross income and therefore met the definition of earned income. In other words, the Tax Court disagreed with the IRS's conclusion in Notice 2014-7 that such payments are excluded from gross income. The IRS has acquiesced in the result in *Feigh*:

> Accordingly, in cases in which the Service permits taxpayers, pursuant to [Notice 2014-7], to treat qualified Medicaid waiver payments as difficulty of care payments excludable under § 131, the Service will not argue that payments that otherwise fall within the definition of earned income under § 32(c)(3) are not earned income for determining eligibility for the EIC and the ACTC merely because they are excludable under the Notice.

E. Divorce Tax Issues

F. Education

G. Alternative Minimum Tax

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

C. Liquidations

D. S Corporations

E. Mergers, Acquisitions and Reorganizations

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

1. State law, not federal common law, must determine whether a refund with respect to a consolidated return belongs to the group's common parent or instead to the subsidiary member whose loss produced the refund, says the U.S. Supreme Court. Rodriguez v. FDIC, 140 S. Ct. 713 (2/24/20). United Western Bancorp, Inc. ("Holding Company") was the common parent of a consolidated group. One member of the consolidated group was a wholly-owned subsidiary, United Western Bank ("Bank"). The Holding Company received a refund of $4.8 million that was produced by carrying back a 2010 consolidated net operating loss (produced by the Bank's loss) to 2008, a year in which the consolidated group had paid tax on income of the Bank. Thus, the refund resulted from revenue generated by the Bank in 2008 and a loss incurred by the Bank in 2010. In the same year the 2010 consolidated return was filed, the Bank was placed into receivership with the FDIC as its receiver. Subsequently, the Holding Company became a debtor in a chapter 7 bankruptcy proceeding. The bankruptcy trustee asserted that the refund was an asset of the bankruptcy estate, and the FDIC asserted that the refund was an asset of the Bank.

The Tenth Circuit's Analysis. The U.S. Court of Appeals for the Tenth Circuit held that the Bank was entitled to the refund. The court noted that, in *Barnes v. Harris*, 783 F.3d 1185 (10th Cir. 2015), the Tenth Circuit, relying on *In re Bob Richards Chrysler-Plymouth Corp., Inc.*, 473 F.2d 262 (9th Cir. 1973), had held *as a matter of federal common law* that, in the absence of a contrary agreement, "a tax refund due from a joint return generally belongs to the company responsible for the losses that form the basis of the refund." In this case, however, the consolidated group members had entered into a tax allocation agreement. The Tenth Circuit ultimately framed the issue as whether, under the tax allocation agreement, the Holding Company was acting as the agent of the Bank or instead had a standard commercial relationship with the Bank. If the former, then the Holding Company was acting as a fiduciary of the Bank and the refund would belong to the Bank; if the latter, then the Bank was a creditor of the Holding Company and the refund would be an asset of the Holding Company's bankruptcy estate. The court concluded that the tax allocation agreement was ambiguous on this point, which triggered a provision in the agreement that required any ambiguity in the agreement to be resolved in favor of the Bank. Accordingly, the court concluded, under the tax allocation agreement the Holding Company was acting as the agent of the Bank and the agreement therefore did not unambiguously depart from the rule of *Barnes* and *Bob Richards*, which meant that the refund belonged to the Bank, the corporation whose losses had produced the refund. The refund therefore was not part of the Holding Company's bankruptcy estate.

The U.S. Supreme Court's Reversal and Remand. In a unanimous opinion by Justice Gorsuch, the U.S. Supreme Court reversed and remanded to the Tenth Circuit. The *Bob Richards* rule for determining ownership of a tax refund in the context of a consolidated return is a rule of federal common law. But the areas in which federal courts may apply federal common law, the Supreme Court observed, are limited and strict conditions must be satisfied before federal courts may do so. One of those conditions, according to the Court's prior decisions, is that, "[i]n the absence of congressional authorization, common lawmaking must be "'necessary to protect uniquely federal interests.'"" That condition, the Court held, is not satisfied in this case. The federal government has no unique interest in how a tax refund is allocated among consolidated group members. In other words, according to the Court, the rule of *Bob Richards* is not a legitimate exercise of federal common lawmaking. The Court held that the issue of ownership of a tax refund in the context of a consolidated corporate group is governed not by federal common law, but by state law, which "is well equipped to handle disputes involving corporate property rights." Because the Tenth Circuit had incorrectly applied federal common law rather than state law, the Court remanded to the Tenth Circuit for further consideration.

H. Miscellaneous Corporate Issues

VII. PARTNERSHIPS

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

F. Liens and Collections

G. Innocent Spouse

H. Miscellaneous

1. Micro-captive insurance transactions are "transactions of interest" that might be on their way to being listed. Notice 2016-66, 2016-47 I.R.B. 745 (11/1/16). This notice identifies certain captive insurance arrangements, referred to as "micro-captive transactions," as transactions of interest for purposes of Reg. § 1.6011-4(b)(6) and §§ 6111 and 6112 of the Code. Generally, these arrangements involve a person who owns an insured business and that same person or a related person also owns an interest in the insurance company providing coverage. The insured business deducts the premiums paid to the insurance company, and the insurance company, by making the election under § 831(b) to be taxed only on taxable investment income, excludes the premiums from gross income. An insurance company making the § 831(b) election can receive up to $2.2 million in premiums annually (adjusted for inflation after 2015). The notice describes the coverage under these arrangements as having one or more of the following characteristics:

> (1) the coverage involves an implausible risk; (2) the coverage does not match a business need or risk of Insured; (3) the description of the scope of the coverage in the Contract is vague, ambiguous, or illusory; or (4) the coverage duplicates coverage provided to Insured by an unrelated, commercial insurance company, and the policy with the commercial insurer often has a far smaller premium.

The Treasury Department and the IRS believe these transactions have a potential for tax avoidance or evasion but lack enough information to determine whether the transactions should be identified specifically as a tax avoidance transaction. Transactions that are the same as, or substantially similar to, the transaction described in § 2.01 of the notice are identified as "transactions of interest" for purposes of Reg. § 1.6011-4(b)(6) and §§ 6111 and 6112 effective November 1, 2016. Persons entering into these transactions after November 1, 2006, must disclose the transaction as described in Reg. § 1.6011-4.

The Treasury Department and the IRS believe these transactions have a potential for tax avoidance or evasion but lack enough information to determine whether the transactions should be identified specifically as a tax avoidance transaction. Transactions that are the same as, or substantially similar to, the transaction described in § 2.01 of the notice are identified as "transactions of interest" for purposes of Reg. § 1.6011-4(b)(6) and §§ 6111 and 6112 effective November 1, 2016. Persons entering into these transactions after November 1, 2006, must disclose the transaction as described in Reg. § 1.6011-4.

a. Participants in micro-captive insurance transactions have until May 1, 2017, to disclose their participation in years for which returns were filed before November 1, 2016. Notice 2017-8, 2017-3 I.R.B. 423 (12/29/16). This notice extends the due date for participants to disclose their participation in the micro-captive insurance transactions described in Notice 2016-66, 2016-47 I.R.B. 745 (11/1/16). Generally, under Reg. § 1.6011-4(e)(2)(i), if a transaction becomes a transaction of interest or a listed transaction after a taxpayer has filed a return reflecting the taxpayer's participation in the transaction, then the taxpayer must disclose the transaction for any year for which the limitations period on assessment was open on the date the transaction was identified as a listed transaction or transaction of interest within 90 calendar days after the date on which the transaction was identified. This meant that, for open years for which returns already had been filed on November 1, 2016 (the date on which Notice 2016-66 was issued), disclosures were due on January 30, 2017. In this notice, the IRS has extended the due date from January 30 to May 1, 2017.

b. Sixth Circuit sides with the IRS against micro-captive advisor's attack on Notice 2016-66 and "reportable transactions." CIC Services, LLC v. Internal Revenue Service, 925 F.3d 247 (6th Cir. 5/22/19). In a 2-1 decision reflected in an opinion by Judge Clay, the U.S. Court of Appeals for the Sixth Circuit affirmed the U.S. District Court's dismissal of a lawsuit against the IRS challenging the IRS's categorization of certain micro-captive insurance arrangements as "reportable transactions" in Notice 2016-66, 2016-47 I.R.B. 745. The plaintiff, CIC Services, LLC, advises taxpayers with respect to micro-captive insurance arrangements. Generally, these arrangements involve a taxpayer who owns an insured business while that same taxpayer or a related person also owns an interest in an insurance company providing coverage to the business. The insured business deducts the premiums paid to the insurance company, and the insurance company, by making the election under § 831(b) to be taxed only on taxable investment income, excludes the premiums from gross income. In 2019, an insurance company making the § 831(b) election could receive up to $2.3 million in excludable premiums. Back in 2016, the IRS issued Notice 2016-66, 2016-47 I.R.B. 745, which identified certain of these micro-captive insurance arrangements as abusive and thus "transactions of interest" for purposes of the "reportable transaction" rules of Code §§ 6111 and 6112 and Reg. § 1.6011-4(b)(6). Significant penalties can be imposed upon taxpayers and their material advisers for failing to comply with the "reportable transaction" rules. The plaintiff took offense at the IRS's position regarding micro-captives and filed suit in the U.S. District Court for the Eastern District of Tennessee to enjoin enforcement of Notice 2016-66. The plaintiff alleged that the IRS had promulgated Notice 2016-66 in violation of the Administrative Procedure Act, 5 U.S.C. § 500 *et seq.* and the Congressional Review Act, 5 U.S.C. § 801 *et seq*. The IRS countered that the plaintiff's complaint was barred by the Anti-Injunction Act, 26 U.S.C. §7421(a), and the tax exception to the Declaratory Judgment Act, 28 U.S.C. § 2201 (together, the "AIA"). Generally, the AIA bars lawsuits filed "for the purpose of restraining the assessment or collection of any tax" by the IRS. Responding to the IRS, the plaintiff characterized its suit as one relating to tax reporting requirements, not tax assessment and collection. Plaintiff therefore contended that its lawsuit was not barred by the AIA. The IRS, on the other hand, argued that the case ultimately was about tax assessment and collection because the penalties imposed under the "reportable transaction" regime are treated as taxes for federal income tax purposes. The plaintiff cited as support for its argument the U.S. Supreme Court's decision in *Direct Marketing Ass'n v. Brohl*, 575 U.S. ___, 135 S.Ct. 1124 (2015), which allowed a lawsuit to proceed against Colorado state tax authorities despite the Tax Injunction Act ("TIA"). The TIA, which protects state tax assessments and collections, is modeled on the AIA. The IRS, on the other hand, argued that the decision of the U.S. Court of Appeals for the District of Columbia Circuit in *Florida Bankers Ass'n v. U.S. Dep't of Treasury*, 799 F.3d 1065 (Fed. Cir. 2015), which distinguished *Direct Marketing*, reflected the proper analysis. The court in *Florida Bankers* held that the AIA applied to bar a suit seeking to enjoin the IRS's enforcement of certain penalties. The suit was barred by the AIA, according to the court in *Florida Marketing*, because the penalties at issue in that case were treated as federal income taxes for assessment and collection purposes, unlike the action challenged in *Direct Marketing*. Writing for the majority, Judge Clay rejected the plaintiff's *Direct Marketing* argument and agreed with the IRS's *Florida Bankers Ass'n* argument. Judge Clay reasoned that, like the penalties at issue in *Florida Bankers Ass'n*, the "reportable transaction" penalties are located in Chapter 68, Subchapter B of the Code and thus are treated as taxes for federal income tax purposes. Therefore, the decision of the U.S. Court of Appeals for the District of Columbia Circuit in *Florida Bankers Ass'n v. U.S. Dep't of Treasury* is directly on point. Judge Clay also ruled that the plaintiff's lawsuit did not fall within any of the exceptions to the AIA. Hence, the AIA barred the plaintiff's lawsuit because the plaintiff, by seeking to enjoin enforcement of Notice 2016-66, is indirectly attempting to thwart the IRS's assessment and collection of a tax.

- Judge Nalhandian dissented and would have held that the suit was not barred by the AIA. He reasoned that the suit involved a challenge to a tax reporting requirement, albeit one with a penalty attached for noncompliance, and that the AIA does not bar challenges to tax reporting requirements.

c. The IRS is making time-limited settlement offers to those with micro-captive insurance arrangements. IR-2019-157 (9/16/19). The IRS has announced that it has begun sending time-limited settlement offers to certain taxpayers with micro-captive insurance arrangements. The IRS has done so following three recent decisions of the U.S. Tax Court that disallowed the tax benefits associated with these arrangements. *See* Syzygy Ins. Co., Inc. v. Commissioner, T.C. Memo. 2019-34 (4/10/19); Reserve Mechanical Corp. v. Commissioner, T.C. Memo. 2018-86 (6/18/18); Avrahami v. Commissioner, 149 T.C. No. 7 (8/21/2017). The terms of the offer , which must be acepted within thirty days of the date of the letter making the offer, generally are as follows: (1) the IRS will deny 90 percent of any deductions claimed for captive insurance premiums; (2) the captive insurance company won't be required to recognize taxable income for received premiums; (3) the captive must already be liquidated, will be required to liquidate, or agree to a deemed liquidation that results in dividend income for the shareholders; (4) the captive will not be required to recognize taxable income for received premiums; (5) accuracy-related penalties are reduced to a rate of 10 percent and can be reduced to 5 percent or 0 percent if certain conditions are met; (6) if none of the parties to the micro-captive insurance transaction disclosed it as required by Notice 2016-66, a single penalty of $5,000 will be applied under § 6707A (Penalty for Failure to Include Rreportable Transaction Information with Return), and (7) additions to tax for failure to file or pay tax under § 6651 and failure to pay estimated income tax under §§ 6654 and 6655 may apply.

d. Approximately 80 percent of taxpayers receiving micro-captive insurance settlement offers accepted them. The IRS is establishing 12 new examination teams that are expected to open audits related to thousands of taxpayers. IR-2020-26 (1/31/20). The IRS previously announced that it had begun sending time-limited settlement offers to certain taxpayers with micro-captive insurance arrangements. The IRS has now announced that "[n]early 80% of taxpayers who received offer letters elected to accept the settlement terms." The announcement also informs taxpayers that "the IRS is establishing 12 new examination teams that are expected to open audits related to thousands of taxpayers in coming months." Finally, the announcement reminds taxpayers that Notice 2016-66 requires disclosure of micro-captive insurance transactions with the IRS Office of Tax Shelter Analysis and that failure to do so can result in significant penalties.

- The authors understand that, in March 2020, the IRS issued Letter 6336 to thousands of taxpayers seeking information about their participation in micro-captive insurance transactions. The letters initially asked for a response by May 4, 2020, which subsequently was extended to June 4, 2020.

e. The U.S. Supreme Court will consider a taxpayer's challenge to Notice 2016-66. CIC Services, LLC v. Internal Revenue Service, Docket No. 19-930 (U.S. 5/4/20). The U.S. Supreme Court has granted the taxpayer's petition for a writ of certiorari in this case, in which the U.S. Court of Appeals for the Sixth Circuit dismissed a lawsuit challenging the IRS's categorization of certain micro-captive insurance arrangements as "reportable transactions" in Notice 2016-66, 2016-47 I.R.B. 745. According to the Court's grant of the writ, the question presented is:

Whether the Anti-Injunction Act's bar on lawsuits for the purpose of restraining the assessment or collection of taxes also bars challenges to unlawful regulatory mandates issued by administrative agencies that are not taxes.

2. You say "FBAR." We say "FUBAR." Although Treasury has failed to update relevant FBAR regulations, the penalty for willful violations is not capped at $100,000 per account, says the Federal Circuit. Norman v. United States, 942 F.3d 1111 (Fed. Cir. 11/8/19), *aff'g* 138 Fed. Cl. 189 (7/31/18). The issue in this case is whether substantial foreign bank account reporting ("FBAR") penalties assessed by the Service were reduced. Under 31 U.S.C. § 5321(a)(5)(A), the Secretary of the Treasury "may impose" a penalty for FBAR violations, and pursuant to administrative orders, the authority to impose FBAR penalties has been delegated by the Secretary to the Service. Further, under the *current* version of 31 U.S.C. § 5321(a)(5)(B)(i), the normal penalty for an FBAR violation is $10,000 per offending account; however, the penalty for a *willful* FBAR violation "shall be increased to the greater of" $100,000 or 50 percent of the balance in the offending account at the time of the violation. *See* 31 U.S.C. § 5321(a)(5)(C). These minimum and maximum penalties for willful FBAR violations were changed by the American Jobs Creation Act of 2004 ("AJCA"), Pub. L. No. 108-357, § 821, 118 Stat. 1418 (2004). The prior version of 31 U.S.C. § 5321(a)(5) provided that the penalty for *willful* FBAR violations was the greater of $25,000 or the balance of the unreported account up to $100,000. Treasury regulations issued under the pre-AJCA version of 31 U.S.C. § 5321(a)(5), reflecting the law at the time, capped the penalty for willful FBAR violations to $100,000 per account. *See* 31 C.F.R. § 1010.820(g). In this case, the government assessed a penalty of $803,500 for failure to file an FBAR in 2007 with respect to a Swiss Bank account. The taxpayer argued that the "may impose" language of the relevant statute, 31 U.S.C. § 5321(a)(5), provides the Secretary of the Treasury with discretion to determine the amount of assessable FBAR penalties and that, because the outdated Treasury regulations had not been amended to reflect the AJCA's increase in the minimum and maximum FBAR penalties, the Service's authority was limited to the amount prescribed by the existing regulations. The court reasoned that the amended statute, which provides that the amount of penalties for willful FBAR violations *shall be* increased to the greater of $100,000 or 50 percent of the account value, is mandatory and removed Treasury's discretion to provide for a smaller penalty by regulation. According to the court, the statute gives Treasury discretion *whether* to impose a penalty in particular cases, but not discretion to set a cap on the penalty that is different than the cap set forth in the statute.

- Several federal district courts and the U.S. Court of Federal Claims have considered this issue and reached different conclusions. For cases holding that the outdated FBAR regulations limit the penalty for willful FBAR violations to $100,000 per account, see *United States v. Wadhan*, 325 F. Supp. 3d 1136 (D. Colo. 7/18/18); *United States v. Colliot*, 121 A.F.T.R.2d 2018-1834 (W.D. Tex. 5/16/18). For cases holding that the outdated FBAR regulations do *not* limit the penalty for willful FBAR violations, see *United States v. Schoenfeld*, 396 F. Supp. 3d 1064 (M.D. Fla. 6/25/19); *United States v. Park*, 389 F. Supp. 3d 561 (N.D. Ill. 5/24/19); *United States v. Garrity*, 123 A.F.T.R.2d 2019-941 (D. Conn. 2/28/19); *United States v. Horowitz*, 361 F. Supp. 3d 511 (D. Md. 1/18/19); *Kimble v. United States*, 141 Fed. Cl. 373 (12/27/18).

a. And another BIG government victory in the FBAR-FUBAR war; however, an appeal to the 11th Circuit was filed almost before the ink was dry on the District Court's decision. United States v. Schwarzbaum, ___ F. Supp.3d ___, 2020 WL 1316232 (S.D. Fl. 3/20/20) (bench trial opinion); United States v. Schwarzbaum, ____ F. Supp.3d _____, 2020 WL 2526500 (5/18/20) (subsequent penalty determination opinion); United States v. Schwarzbaum, 2020 WL 2526500 (6/3/2020) (notice of appeal to the Eleventh Circuit). In this significant FBAR case, the United States District Court for the Southern District of Florida (Judge Bloom) upheld the Service's imposition of almost $13 million in penalties for willful FBAR violations across the years 2007-2009, although the court also ruled that no penalties should be imposed for 2006. The taxpayer, a German and U.S. citizen, owned multiple foreign bank accounts across the years in issue. The largest accounts were given to the taxpayer by his German father and were held in Switzerland. The taxpayer also had a smaller account that he had established at a bank in Costa Rica. The taxpayer credibly testified that for the years 2006-2009 he had been erroneously advised by his tax return preparers that he did not need to report foreign held bank accounts provided the accounts had no U.S. connection. For this reason, Judge Bloom found that the taxpayer's alleged FBAR violations for 2006 were not willful. In 2007, however, the taxpayer self-prepared an FBAR disclosure for his account in Costa Rica. The Costa Rican account had been funded with money accumulated by the taxpayer in the U.S. The taxpayer testified that he thus believed the Costa Rican account had a "U.S. connection" and, accordingly, was the only account subject to FBAR reporting obligations. The Service argued, though, that the 2007 instructions to the FBAR disclosure clearly state that *all foreign bank accounts* of taxpayers should be reported. The instructions do not condition a taxpayer's FBAR disclosure obligation on a "U.S. connection" to the account. Therefore, the Service argued, and Judge Bloom agreed, that despite the (erroneous) advice of his tax return preparers, the taxpayer's FBAR violations for the years 2007-2009 were willful. Judge Bloom reasoned that after 2006 the taxpayer either had constructive knowledge that his tax return preparer's advice was erroneous, or the taxpayer recklessly disregarded his FBAR obligations. In either case, Judge Bloom held that a willfulness finding was appropriate and that the Service's imposition of roughly $13 million (approximately) in FBAR penalties against the taxpayer for the years 2007-2009 was justified.

Contrary to the cases mentioned above, the taxpayer apparently did not argue that the Service's assessed FBAR penalties conflicted with Treasury's outdated regulations. Instead, the taxpayer argued that even if his FBAR violations for 2007-2009 were found to be willful, the $13 million (approximately) penalty assessment violated the Eighth Amendment to the U.S. Constitution. The Eighth Amendment provides that "Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted." The taxpayer argued that the FBAR penalties imposed upon him by the Service were "fines" and were "excessive." In response to the taxpayer's Eighth Amendment argument, Judge Bloom ruled that the FBAR penalties, like most tax penalties, are remedial, not punitive, in nature. In other words, the FBAR penalties are designed to safeguard the revenue of the U.S. and to reimburse the Service and Treasury for the expense of investigating and uncovering the taxpayer's circumvention of U.S. tax laws. Therefore, Judge Bloom held, the FBAR penalties imposed upon the taxpayer are not "fines" subject to the Eighth Amendment. Because the court held that the FBAR penalties are not "fines," the court did not rule on whether the approximately $13 million in penalties imposed upon the taxpayer were "excessive." As noted above, the taxpayer has filed an appeal with the Eleventh Circuit.

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

A. <u>Enacted</u>

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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

I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

C. Reasonable Compensation

D. Miscellaneous Deductions

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

> **(1) In General.—**No deduction shall be allowed under this chapter for any expense incurred for providing any transportation, or any payment or reimbursement, to an

employee of the taxpayer in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee.

(2) Exception.—In the case of any qualified bicycle commuting reimbursement (as described in section 132(f)(5)(F)), this subsection shall not apply for any amounts paid or incurred after December 31, 2017, and before January 1, 2026.

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

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

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

Employer Pays a Third Party for Employee Parking Spots. According to the notice, in situations in which an employer pays a third party an amount so that employees may park at the third party's parking lot or garage, the amount disallowed by § 274(a)(4) generally is the taxpayer's total annual cost of employee parking paid to the third party. Nevertheless, if the amount paid by the employer exceeds the § 132(f)(2) monthly limitation on exclusion ($265 for 2019 and $270 for 2020), the employer must treat the excess amount as compensation and wages to the employee. Accordingly, the excess amount is not disallowed as a deduction pursuant to § 274(e)(2), which provides that § 274(a) does not disallow a deduction for an expense relating to goods, services, and facilities to the extent the taxpayer treats the expense as wages paid to its employees. The result is that the employer can deduct the monthly cost of parking provided to an employee to the extent the cost exceeds the § 132(f)(2) monthly limitation. These rules are illustrated by examples 1 and 2 in the notice.

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

b. Who knew that determining the tax consequences of providing parking or transportation to employees could get so complicated? Proposed regulations address determining the nondeductible portion of qualified transportation fringe benefits. REG-119307-19, Qualified Transportation Fringe, Transportation and Commuting Expenses Under Section 274, 85 F.R. 37599 (6/23/20). These proposed regulations implement two legislative changes made by section 13304(c) of the 2017 Tax Cuts and Jobs Act, which added § 274(a)(4) and § 274(*l*) to the Code. Section 274(a)(4) disallows the deduction of any "qualified transportation fringe" (as defined in § 132(f)) provided to an employee of the taxpayer in taxable years beginning after 2017. A qualified transportation fringe is any of the following provided by an employer to an employee. (1) transportation in a commuter highway vehicle in connection with travel between the employee's residence and place of employment, (2) any transit pass, (3) qualified parking, and (4) any qualified bicycle commuting reimbursement. Section 274(*l*) disallows the deduction of any expense incurred for providing any transportation (or any payment or reimbursement) to an employee of the taxpayer in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee, but does not disallow any qualified bicycle commuting reimbursement (as described in section 132(f)(5)(F)) paid or incurred after 2017 and before 2026.

Disallowance of deductions for qualified transportation fringe benefits. Prop. Reg. § 1.274-(13) provides rules implementing the § 274(a)(4) disallowance of deductions for qualified transportation fringe benefits. With respect to qualified parking provided to employees, the proposed regulations follow the approach of Notice 2018-99 in distinguishing between employers who pay a third party to permit employees to park at the third party's parking lot or garage and employers who own or lease all or a portion of a parking facility. The proposed regulations, however, refine and expand the guidance provided in Notice 2018-99 by, among other things, defining a number of key terms (such as the terms "employee" and "total parking expenses") and providing simplified methodologies that employers who own or lease parking facilities can use to determine the nondeductible portion of their parking expenses. Further, the proposed regulations address the treatment of so-called "mixed parking expenses," which are amounts paid or incurred by a taxpayer that include both nonparking and parking facility expenses, such as lease payments that entitle the employer to use both office space and spaces in a parking garage. The proposed regulations also permit employers that own or lease parking facilities to aggregate parking spaces within a single geographic location (defined as contiguous tracts or parcels of land owned or leased by the taxpayer) for certain purposes.

Employer Pays a Third Party for Employee Parking Spots. According to Prop. Reg. § 1.1.274-13((d)(1), in situations in which an employer pays a third party an amount so that employees may park at the third party's parking lot or garage, the amount disallowed by § 274(a)(4) generally is the taxpayer's total annual cost of employee parking paid to the third party. Nevertheless, under Code § 274(e)(2) and Prop. Reg. 1.274-13(e)(1), the disallowance of deductions for qualified transportation fringes does not apply to an expense relating to goods, services, and facilities to the extent the taxpayer treats the expense as wages paid to its employees. Accordingly, if the amount paid by the employer exceeds the § 132(f)(2) monthly limitation on the employee's exclusion ($265 for 2019 and $270 for 2020), the employer must treat the excess amount as compensation and wages to the employee. The excess amount is not disallowed as a deduction provided that the employer treats the expense both as compensation on its federal income tax return and as wages subject to withholding. The result is that the employer can deduct the monthly cost of parking provided to an employee to the extent the cost exceeds the § 132(f)(2) monthly limitation. These rules are illustrated by examples 1 and 2 in Prop. Reg. § 1.274-13(e)(3).

Taxpayer Owns or Leases All or a Portion of a Parking Facility. Under Prop. Reg. § 1.274-13(d)(2), if a taxpayer owns or leases all or a portion of one or more parking facilities where employees park, the nondeductible portion of the cost of providing parking can be calculated using either a general rule or one of three simplified methodologies. Under the general rule, an employer can determine the nondeductible portion of parking expenses "based on a reasonable interpretation of section 274(a)(4)." A method will not be treated as based on a reasonable interpretation if it uses the *value* of parking provided to employees to determine parking expenses (because § 274(a)(4) disallows a deduction for the *expense* of providing a qualified transportation fringe), results in deducting expenses related to reserved employee spaces, or improperly applies the exception in § 274(e)(7) for qualified parking made available to the public (e.g., by treating a parking facility regularly used by employees as available to the public merely because the general public has access to the parking facility). There are three simplified methodologies than a taxpayer can use as an alternative to the general rule. *First*, a taxpayer can use the "qualified parking limit methodology," which determines the disallowed portion of parking costs by multiplying the § 132(f)(2) monthly limitation on the employee's exclusion ($265 for 2019 and $270 for 2020) for each month in the taxable year by the total number of spaces used by employees during the "peak demand period" (a defined term) or by number of employees. For example, an employer with 10 employees who provides parking to all of them each day for the full year would have $32,400 in disallowed parking costs (10 * $270 *12) for the year. This method is illustrated by example 3 in Prop. Reg. § 1.274-13(e)(3). *Second*, a taxpayer can use the "primary use methodology," which is essentially the same as the four-step methodology provided in Notice 2018-99 that, according to the notice, is deemed to be a reasonable method of determining the nondeductible portion of parking costs. Under the four-step methodology provided in the notice, employers can determine the nondeductible portion of parking costs by: **(1)** determining the percentage of parking spots that are reserved exclusively for employees and treating that percentage of total parking expenses as disallowed; **(2)** determining whether the primary use of the remaining spots (greater than 50 percent actual or estimated usage) is providing parking to the general public, in which case the remaining portion of total parking expenses is not disallowed by § 274(a)(4); **(3)** if the primary use of the remaining parking spots (from step 2) is *not* to provide parking to the general public, identifying the number of remaining spots exclusively reserved for nonemployees, including visitors, customers, partners, sole proprietors, and 2-percent shareholders of S Corporations and treating this percentage of total parking expenses as not disallowed by § 274(a)(4); and **(4)** if there are any remaining parking expenses not specifically categorized as deductible or nondeductible after completing steps 1-3, the taxpayer must reasonably allocate the remaining expenses by determining "the total number of available parking spaces used by employees during the peak demand period." This four-step methodology is illustrated by examples 4 through 9 in Prop. Reg. § 1.274-13(e)(3). *Third*, a taxpayer can use the "cost per space methodology," which determines the disallowed portion of parking costs by multiplying the employer's cost per space (total parking expenses divided by total parking spaces) by the total number of available parking spaces used by employees during the peak demand period. As defined in Prop. Reg. § 1.274-13(b)(12), the term "*total parking expenses*," a portion of which is disallowed, includes, without limitation, "repairs, maintenance, utility costs, insurance, property taxes, interest, snow and ice removal, leaf removal, trash removal, cleaning, landscape costs, parking lot attendant expenses, security, and rent or lease payments or a portion of a rent or lease payment (if not broken out separately)." However, the term total parking expenses does *not* include a deduction for depreciation on a parking facility used for parking by the taxpayer's employees.

Disallowance of non-QTF expenses incurred for employee travel from residence to place of employment. Prop. Reg. § 1.274-14 implements the §274(*l*) disallowance of deductions for expenses incurred for providing transportation (or a payment o reimbursement) to an employee in connection with the employee's travel between the employee's residence and place of employment. This disallowance does not apply if the transportation or commuting expense is necessary to endure the safety of the employee. The disallowance also does not apply to qualified transportation fringes, which must be analyzed under the rules previously discussed. This proposed regulation is very brief and provides no examples.

Effective dates. According to Pro. Reg. §§ 1.274-13(g) and § 1.274-14(c), the proposed regulations will apply for taxable years that begin on or after the date on which the final regulations are published in the Federal Register. The preamble adds that, until final regulations are issued, taxpayers can rely on the proposed regulations or, alternatively, can rely on the guidance in Notice 2018-99.

E. Depreciation & Amortization

F. Credits

G. Natural Resources Deductions & Credits

H. Loss Transactions, Bad Debts, and NOLs

I. At-Risk and Passive Activity Losses

III. INVESTMENT GAIN AND INCOME

IV. COMPENSATION ISSUES

A. Fringe Benefits

B. Qualified Deferred Compensation Plans

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

D. Individual Retirement Accounts

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

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

D. Deductions and Credits for Personal Expenses

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

a. The IRS is not going to give blue states a pass on creative workarounds to the new $10,000 limitation on the personal deduction for state and local taxes. Notice 2018-54, 2018-24 I.R.B. 750 (05/23/18). In response to new § 164(b)(6), many states—including Connecticut, New Jersey, and New York—have enacted workarounds to the $10,000 limitation. For instance, New Jersey reportedly has enacted legislation giving property owners a special tax credit against otherwise assessable property taxes if the owner makes a contribution to charitable funds designated by local governments. Connecticut reportedly has enacted a new provision that taxes the income of pass-through entities such as S corporations and partnerships, but allows the shareholders or members a corresponding tax credit against certain state and local taxes assessed against them individually. Notice 2018-54 announces that the IRS and Treasury are aware of these workarounds and that proposed regulations will be issued to "make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers." In other words, blue states, don't bank on a charitable contribution or a flow-through income tax substituting for otherwise assessable state and local taxes to avoid new § 164(b)(6). The authors predict that this will be an interesting subject to watch over the coming months.

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

c. More about trouble spots: The IRS must be thinking, "Will this ever end?" Rev. Proc. 2019-12, 2019-04 I.R.B. 401 (12/29/18). Notwithstanding the above guidance, Treasury and the IRS obviously have continued to receive questions regarding the deductibility of business expenses that may indirectly bear on the taxpayer's state and local tax liability. In response, Rev. Proc. 2019-12 provides certain safe harbors. For C corporations that make payments to or for the use of § 170(c) charitable organizations and that receive or expect to receive corresponding tax credits against state or local taxes, the C corporation nevertheless may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of § 162(a). A similar safe harbor rule applies for entities other than C corporations, but only if the entity is a "specified passthrough entity." A specified passthrough entity for this purpose is one that meets four requirements. First, the entity must be a business entity other than a C corporation that is regarded for all federal income tax purposes as separate from its owners under Reg. § 301.7701-3 (i.e., it is not single-member LLC). Second, the entity must operate a trade or business within the meaning of § 162. Third, the entity must be subject to a state or local tax incurred in carrying on its trade or business that is imposed directly on the entity. Fourth, in return for a payment to a § 170(c) charitable organization, the entity receives or expects to receive a state or local tax credit that the entity applies or expects to apply to offset a state or local tax imposed upon the entity. The revenue procedure applies to payments made on or after January 1, 2018.

C corporation example state and local income tax credit: A, a C corporation engaged in a trade or business, makes a payment of $1,000 to a § 170(c) charitable organization. In return for the payment, A receives or expects to receive a dollar-for-dollar state tax credit to be applied to A's state corporate income tax liability. Under the revenue procedure, A may treat the $1,000 payment as meeting the requirements of an ordinary and necessary business expense under § 162.

C corporation example state and local property tax credit: B, a C corporation engaged in a trade or business, makes a payment of $1,000 to a § 170(c) charitable organization. In return for the payment, B receives or expects to receive a tax credit equal to 80 percent of the amount of this payment ($800) to be applied to B's local real property tax liability. Under the revenue procedure, B may treat $800 as meeting the requirements of an ordinary and necessary business expense under § 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by the revenue procedure. (In other words, the $200 could be a charitable contribution deductible under § 170, or the $200 could be a business expense deductible under § 162.)

Specified passthrough example state and local property tax credit: S is an S corporation engaged in a trade or business and is owned by individuals C and D. S makes a payment of $1,000 to a § 170(c) charitable organization. In return for the payment, S receives or expects to receive a state tax credit equal to 80 percent of the amount of this payment ($800) to be applied to S's local real property tax liability incurred by S in carrying on its trade or business. Under applicable state and local law, the real property tax is imposed at the entity level (not the owner level). Under the revenue procedure, S may treat $800 of the payment as meeting the requirements of an ordinary and necessary business expense under § 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by this revenue procedure. (In other words, the $200 could be a charitable contribution deductible under § 170 by the owners of the specified passthrough entity, or the $200 could be a business expense deductible at the entity level under § 162.)

d. And like Rameses II in The Ten Commandments, Treasury says, "So let it be written; so let it (finally!) be done." T.D. 9864, Contributions in Exchange for State or Local Tax Credits, 84 F.R. 27513 (6/13/19). The Treasury Department and the IRS have finalized, with only minor changes, proposed amendments to the regulations under § 170 that purport to close the door on any state-enacted workarounds to the $10,000 limitation of § 164(b)(6) on a taxpayer's itemized deductions on Schedule A for the aggregate of state or local property taxes, income taxes, and sales taxes deducted in lieu of income taxes. (*See* REG-112176-18, Contributions in Exchange for State and Local Tax Credits, 83 F.R. 43563 (8/27/18).) Reg. § 1.170A-1(h)(3) generally requires taxpayers to reduce the amount of any federal income tax charitable contribution deduction by the amount of any corresponding state or local tax *credit* the taxpayer receives or expects to receive. The final regulations further provide that a corresponding state or local tax *deduction* normally will not reduce the taxpayer's federal deduction provided the state and local deduction does not exceed the taxpayer's federal deduction. To the extent the state and local charitable deduction exceeds the taxpayer's federal deduction, the taxpayer's federal deduction is reduced. Finally, the final regulations provide an exception whereby the taxpayer's federal charitable contribution deduction is not reduced if the corresponding state or local credit does not exceed 15 percent of the taxpayer's federal deduction. Pursuant to an amendment to Reg. § 1.642(c)-3(g), these same rules apply in determining the charitable contribution deductions of trusts and estates under § 642(c). Three examples illustrate the application of these rules:

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

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

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

Effective date. The final regulations are effective for charitable contributions made after August 27, 2018.

And another thing . . . . The final regulations do not discern between abusive "workarounds" enacted in response to § 164(b)(6) and legitimate state and local tax credit programs such as the

Georgia Rural Hospital Tax Credit that preceded the 2017 Tax Cuts and Jobs Act. The Georgia Rural Hospital Tax Credit program was enacted in 2017 to combat the closure of many rural hospitals in Georgia due to financial difficulties. Under the program, individuals and corporations making contributions to designated rural hospitals receive a 90 percent dollar-for-dollar tax credit against their Georgia state income tax liability. Is the Georgia Rural Hospital Tax Credit program adversely affected by proposed regulations under § 164(b)(6)? In our view, the answer is "yes" and a Georgia taxpayer's federal charitable contribution deduction for a donation to a Georgia rural hospital is reduced by 90 percent. Treasury and the IRS have adopted this view, which is reflected in the preamble to the final regulations:

> The regulations are based on longstanding federal tax law principles that apply equally to all taxpayers. To ensure fair and consistent treatment, the final regulations do not distinguish between taxpayers who make transfers to state and local tax credit programs enacted after the [Tax Cuts and Jobs] Act and those who make transfers to tax credit programs existing prior to the enactment of the Act. Neither the intent of the section 170(c) organization, nor the date of enactment of a particular state tax credit program, are relevant to the application of the *quid pro quo* principle.
>
> We note, however, that it may be possible under state or local law for a taxpayer to waive any corresponding state or local tax credit and thereby claim a full charitable contribution for federal income tax purposes. *See* Rev. Rul. 67-246, 1967-2 C.B. 104. In the preamble to the final regulations, Treasury and the IRS noted that taxpayers might disclaim a credit by not applying for it if the credit calls for an application (or applying for a lesser amount) and requested comments as to how taxpayers may decline state or local tax credits in other situations. It is also possible, pursuant to a safe harbor established in Notice 2019-12, 2019-27 I.R.B. 57 (see below), for an individual who itemizes deductions to treat as a payment of state or local tax on Schedule A a payment made to a charitable organization for which the individual receives a state or local tax credit.

e. Down the rabbit hole we go. A safe harbor allows individuals who itemize to treat as payments of state or local tax any payments to § 170(c) charitable organizations that are disallowed as federal charitable contribution deductions because the individual will receive a state or local tax credit for the payment. Notice 2019-12, 2019-27 I.R.B. 57 (6/11/19). This notice announces that the Treasury Department and the IRS intend to publish a proposed regulation that will amend Reg. § 164-3 to provide a safe harbor for individuals who itemize deductions and make a payment to or for the use of an entity described in § 170(c) in return for a state or local tax credit. Until the proposed regulations are issued, taxpayers can rely on the safe harbor as set forth in the notice. Section 3 of the notice provides as follows:

> Under this safe harbor, an individual who itemizes deductions and who makes a payment to a section 170(c) entity in return for a state or local tax credit may treat as a payment of state or local tax for purposes of section 164 the portion of such payment for which a charitable contribution deduction under section 170 is or will be disallowed under final regulations. This treatment as a payment of state or local tax under section 164 is allowed in the taxable year in which the payment is made to the extent the resulting credit is applied, consistent with applicable state or local law, to offset the individual's state or local tax liability for such taxable year or the preceding taxable year. … To the extent the resulting credit is not applied to offset the individual's state or local tax liability for the taxable year of the payment or the preceding taxable year, any excess credit permitted to be carried forward may be treated as a payment of state or local tax under section 164 in the taxable year or years for which the carryover credit is applied, consistent with applicable state or local law, to offset the individual's state or local tax liability.

The safe harbor does not apply to a transfer of property and does not permit a taxpayer to treat the amount of any payment as deductible under more than one provision of the Code or regulations. The safe harbor applies to payments made after August 27, 2018. Three examples illustrate the application of these rules:

Example 1. In year 1, Taxpayer A makes a payment of $500 to an entity described in section 170(c). In return for the payment, A receives a dollar-for-dollar state income tax credit. Prior to application of the credit, A's state income tax liability for year 1 was $500 or more; A applies the $500 credit to A's year 1 state income tax liability. Under section 3 of this notice, A treats the $500 payment as a payment of state income tax in year 1 for purposes of section 164. To determine A's deduction amount, A must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).

Example 2. In year 1, Taxpayer B makes a payment of $7,000 to an entity described in section 170(c). In return for the payment, B receives a dollar-for-dollar state income tax credit, which under state law may be carried forward for three taxable years. Prior to application of the credit, B's state income tax liability for year 1 was $5,000; B applies $5,000 of the $7,000 credit to B's year 1 state income tax liability. Under section 3 of this notice, B treats $5,000 of the $7,000 payment as a payment of state income tax in year 1 for purposes of section 164. Prior to application of the remaining credit, B's state income tax liability for year 2 exceeds $2,000; B applies the excess credit of $2,000 to B's year 2 state income tax liability. For year 2, B treats the $2,000 as a payment of state income tax for purposes of section 164. To determine B's deduction amounts in years 1 and 2, B must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).

Example 3. In year 1, Taxpayer C makes a payment of $7,000 to an entity described in section 170(c). In return for the payment, C receives a local real property tax credit equal to 25 percent of the amount of this payment ($1,750). Prior to application of the credit, C's local real property tax liability in year 1 was $3,500; C applies the $1,750 credit to C's year 1 local real property tax liability. Under section 3 of this notice, for year 1, C treats $1,750 as a payment of local real property tax for purposes of section 164. To determine C's deduction amount, C must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).

f. Final regulations reflect previously issued guidance on payments to § 170(c) charitable organizations that result in state or local tax credits and provide additional guidance. TD 9907, Treatment of Payments to Charitable Entities in Return for Consideration, 85 F.R. 48467 (8/11/20). The Treasury Department and the IRS have finalized proposed regulations (REG-107431-19, Treatment of Payments to Charitable Entities in Return for Consideration, 84 F.R. 68833 (12/17/19)) that reflect previously issued guidance, including safe harbors, regarding payments to § 170(c) charitable organizations that result in state or local tax credits. The final regulations generally provide the following guidance.

Amendments to clarify the standard for payments to a charitable organization to qualify as a business expense. The final regulations amend Reg. § 1.162-15(a) to provide:

> A payment or transfer to or for the use of an entity described in section 170(c) that bears a direct relationship to the taxpayer's trade or business and that is made with a reasonable expectation of financial return commensurate with the amount of the payment or transfer may constitute an allowable deduction as a trade or business expense rather than a charitable contribution deduction under section 170.

See also Reg. § 1.170A-2(c)(5). This revision is intended to more clearly reflect current law regarding when payments from a business to a charitable organization qualify as a business expense (rather than as a charitable contribution). The regulations provide two examples, both of which involve businesses making payments to a § 170(c) charitable organization in exchange for advertising (e.g., a half-page advertisement in the program for a church concert) or to generate name recognition and goodwill (e.g., donating 1 percent of gross sales to charity each year). These amendments apply to amounts paid or property transferred after December 17, 2019. Nevertheless, taxpayers can choose to apply the amendments to payments or transfers made on or after January 1, 2018.

Safe harbors for payments by C corporations and specified pass-through entities to § 170(c) entities. The final regulations reflect amendments to Reg. § 1.162-15(a) to incorporate the safe harbors previously set forth in Rev. Proc. 2019-12, 2019-04 I.R.B. 401 (12/29/18). One safe harbor provides that C corporations that make payments to or for the use of § 170(c) charitable organizations and that receive or expect to receive corresponding tax credits against state or local taxes may treat such payments as meeting the requirements of an ordinary and necessary business expense for purposes of § 162(a). A similar safe harbor rule applies for entities other than C corporations, but only if the entity is a "specified passthrough entity." A specified passthrough entity for this purpose is one that meets four requirements. First, the entity must be a business entity other than a C corporation that is regarded for all federal income tax purposes as separate from its owners under Reg. § 301.7701-3 (i.e., it is not single-member LLC). Second, the entity must operate a trade or business within the meaning of § 162. Third, the entity must be subject to a state or local tax incurred in carrying on its trade or business that is imposed directly on the entity. Fourth, in return for a payment to a § 170(c) charitable organization, the entity receives or expects to receive a state or local tax credit that the entity applies or expects to apply to offset a state or local tax imposed upon the entity. The safe harbors for C corporations and specified passthrough entities apply only to payments of cash and cash equivalents. *See* Reg. § 1.162-15(a)(3)(iii). The safe harbor for specified passthrough entities does not apply if the credit received or expected to be received reduces a state or local income tax. *See* Reg. § 1.162-15(a)(3)(ii)(C). These amendments apply to amounts paid or property transferred after December 17, 2019. Nevertheless, taxpayers can choose to apply the amendments to payments or transfers made on or after January 1, 2018.

A safe harbor for individuals who itemize deductions. The final regulations amend Reg. § 1.164-3(j) to incorporate the safe harbor previously provided in Notice 2019-12, 2019-27 I.R.B. 57 (6/11/19). Under this safe harbor, an individual who itemizes deductions and who makes a payment to a § 170(c) entity in return for a state or local tax credit may treat as a payment of state or local tax for purposes of § 164 the portion of the payment for which a charitable contribution deduction under § 170 is disallowed by Reg. § 1.170A-1(h)(3). This latter regulation generally disallows a taxpayer's federal charitable contribution deduction to the extent the taxpayer receives a state or local tax credit in exchange for a payment to a § 170(c) entity. For example, this safe harbor would permit an individual who makes a $1,000 payment to a § 170(c) entity and who, in exchange, receives a $700 state or local tax credit to treat the $700 that is disallowed as a federal charitable contribution deduction as a payment of state or local tax that is deductible on Schedule A, subject to the $10,000 limit of § 164(b)(6). These amendments apply to payments made on or after June 11, 2019 (the date the IRS issued Notice 2019-12), but individuals can choose to apply the amendments to Reg. § 1.164-3(j) to payments made after August 27, 2018.

Amendments to clarify the effect of benefits provided to a donor that are not provided by the § 170(c) entity. The final regulations propose amending Reg. § 1.170A-1(h)(4)(i) to provide:

> A taxpayer receives goods or services in consideration for a taxpayer's payment or transfer to an entity described in section 170(c) if, at the time the taxpayer makes the payment to such entity, the taxpayer receives or expects to receive goods or services from that entity or any other party in return.

This amendment is intended to clarify that the *quid pro quo* principle, under which a taxpayer's charitable contribution deduction is disallowed to the extent the taxpayer receives goods or services in return, applies regardless of whether the goods or services are provided by the § 170(c) entity receiving the contribution. The preamble to the proposed regulations discussed judicial decisions that have adopted this approach, such as *Singer v. United States*, 449 F.2d 413(Ct. Cl. 1971) and *Wendell Falls Development, LLC v. Commissioner*, T.C. Memo. 2018-45. The IRS reached a similar result in example 11 of Rev. Rul. 67-246, 1967-2 C.B. 104, in which a taxpayer who made a $100 payment to a specific charity and, in return, received a transistor radio worth $15 from a local store could take a charitable contribution deduction of only $85. The final regulations also amend Reg. § 1.170A-1(h)(4)(ii) to define "goods or services" for this purpose as "cash, property, services, benefits, and privileges." These amendments apply to amounts paid or property transferred after December 17, 2019.

2. Dependency Defined! Treasury releases proposed regulations clarifying the definition of a "qualifying relative". REG-118997-19, Dependent Defined; Notice of Proposed Rulemaking and Partial Withdrawal of Notice of Proposed Rulemaking, 85 FR 35233 (June 9, 2020).

Treasury and the IRS have issued newly proposed regulations revising old proposed regulations issued in January 2017 to clarify the definition of who is a “qualifying relative” for tax years 2018 through 2025. In general, taxpayers may claim an exemption deduction for the taxpayer, his or her spouse, and for any dependents (“qualifying child” or a “qualifying relative”). §§ 151; 152(a). Importantly, to be a qualifying relative, the individual’s gross income must be less than the exemption amount in § 151(d). Before the 2017 old proposed regulations and the enactment of the Tax Cuts and Jobs Act (TCJA), § 151(d) provided for an inflation adjusted exemption for 2018 of $4,150. However, the TCJA added § 151(d)(5) providing that, for the years 2018-2025, the exemption amount is zero. Essentially, the TCJA, suspended the personal and dependency exemption deductions. However, the reduction of the exemption amount to zero should not and does not impact whether a taxpayer is allowed or entitled to a deduction for purposes of any other provision of the Code. § 151(d)(5)(B). Specifically, the Conference Report clarifies that the reduction of the personal exemption to zero “should not alter the operation of those provisions of the Code which refer to a taxpayer allowed a deduction . . . under section 151” including the child tax credit in § 24(a). Conference Report at 203 n.16. The TCJA also amended § 24 to allow for a $500 credit for qualifying relatives as defined in § 152(d). See § 24(h)(4)(A). The $500 credit for qualifying relatives also applies for the years 2018 through 2025. Thus, the reduction of the exemption amount to zero during these years is not taken into account in determining whether an individual meets the definition of qualifying relative. Notice 2018-70, 2018-38 I.R.B. 441. Newly proposed Reg. § 1.152-3(c)(3)(i) provides in part:

> For tax year 2018, the exemption amount under section 152 (d)(1)(B) is $4,150. For tax years 2019 through 2025, the exemption amount, as adjusted for inflation, is set forth in annual guidance published in the Internal Revenue Bulletin. See § 601.601(d)(2) of this chapter…

As such, Prop. Reg. § 1.152-3(c)(3), defining “qualifying relative,” provides for an inflation adjusted exemption amount for 2019-2025. Treasury argues that this language in the newly proposed regulation is supported by the wording of § 152(d)(1)(B). To be included in the definition of a “qualifying relative” under the wording of § 152(d)(1)(B), an individual must have gross income that is “less than the exemption amount.” If the exemption amount were zero, such an individual's gross income would have to be less than zero. Such an interpretation would make no sense because, under such circumstances, no individual would meet the definition of a qualifying relative. Treasury further supports this interpretation by concluding that Congress could not have intended to make such a significant change in such an indirect manner. For the same reasons, the newly proposed regulations provide for similar amendments to Prop. Reg. § 1.24-1, Partial credit allowed for certain other dependents, and subsection (d) of Prop. Reg. 1.152-3(d), relating to alimony and separate maintenance payments as well.

E. Divorce Tax Issues

F. Education

G. Alternative Minimum Tax

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

C. Liquidations

D. S Corporations

E. Mergers, Acquisitions and Reorganizations

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

VII. PARTNERSHIPS

A. Formation and Taxable Years

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

C. Distributions and Transactions Between the Partnership and Partners

D. Sales of Partnership Interests, Liquidations and Mergers

E. Inside Basis Adjustments

F. Partnership Audit Rules

G. Miscellaneous

1. Relief for not reporting negative tax capital accounts. Notice 2019-20, 2019-14 I.R.B. 927 (3/7/19). The updated 2018 Instructions for Form 1065 and accompanying Schedule K-1 now require a partnership that does not report tax basis capital accounts to its partners to report, on line 20 of Schedule K-1 (Form 1065) using code AH, the amount of a partner's tax basis capital both at the beginning of the year and at the end of the year if either amount is negative. Aware that some taxpayers and their advisors may not have been prepared to comply with this new requirement for 2018 returns, the IRS, in Notice 2019-20, has provided limited relief. Specifically, the IRS will waive penalties (1) under § 6722 for failure to furnish a partner a Schedule K-1 (Form 1065) and under § 6698 for failure to file a Schedule K-1 (Form 1065) with a partnership return, (2) under § 6038 for failure to furnish a Schedule K-1 (Form 8865), and (3) under any other section of the Code for failure to file or furnish a Schedule K-1 or any other form or statement, for any penalty that arises solely as a result of failing to include negative tax basis capital account information provided the following conditions are met:

1. The Schedule K-1 or other applicable form or statement is timely filed, including extensions, with the IRS; is timely furnished to the appropriate partner, if applicable; and contains all other required information.
2. The person or partnership required to file the Schedule K-1 or other applicable form or statement files with the IRS, no later than one year after the original, unextended due date of the form to which the Schedule K-1 or other applicable form or statement must be attached, a schedule setting forth, for each partner for which negative tax basis capital account information is required: (a) the partnership's name and Employer Identification Number, if any, and Reference ID Number, if any; (b) the partner's name, address, and taxpayer identification

number; and (c) the amount of the partner's tax basis capital account at the beginning and end of the tax year at issue.

The above-described supplemental schedule should be captioned "Filed Under Notice 2019-20" in accordance with instructions and additional guidance posted by the IRS on www.IRS.gov. The due date for this supplemental schedule is determined without consideration of any extensions, automatic or otherwise, that may apply to the due date for the form itself. Furthermore, the schedule should be sent to the address listed in the Notice, and the penalty relief applies only for taxable years beginning after December 31, 2017, but before January 1, 2019.

a. The IRS has issued FAQ guidance on negative tax basis capital account reporting. The IRS has issued guidance on the requirement to report negative tax basis capital account information in the form of frequently asked questions (FAQs) on its website. The FAQs are available at ***https://www.irs.gov/businesses/partnerships/form-1065-frequently-asked-questions***.

Definition and calculation of tax basis capital accounts. In the FAQs, the IRS explains that "[a] partner's tax basis capital account (sometimes referred to simply as 'tax capital') represents its equity as calculated using tax principles, not based on GAAP, § 704(b), or other principles." The FAQs provide guidance on the calculation of a partner's tax basis capital account. A partner's tax basis capital account is *increased by the amount of money and the adjusted basis of any property contributed* by the partner to the partnership (less any liabilities assumed by the partnership or to which the property is subject) and is *decreased by the amount of money and the adjusted basis of any property distributed by the partnership to the partner* (less any liabilities assumed by the partner or to which the property is subject). The partner's tax basis capital account is increased by certain items, such as the partner's distributive share of partnership income and gain, and is decreased by certain items, such as the partner's distributive share of partnership losses and deductions. The FAQs make clear that a partner's tax basis capital account is not the same as a partner's basis in the partnership interest (outside basis) because outside basis includes the partner's share of partnership liabilities, whereas a partner's tax basis capital account does not.

Effect of § 7*54 Elections and Revaluations of Partnership Property.* If a partnership has a § 754 election in effect, then it increases or decreases the adjusted basis of partnership property pursuant to § 743(b) when there is a transfer of a partnership interest or pursuant to § 734(b) when there is a distribution by the partnership. These adjustments can also be triggered when the partnership does not have a § 754 election in effect but has a substantial built-in loss and a transfer of a partnership interest occurs (§ 743(b) basis adjustment) or experiences a substantial basis reduction in connection with a distribution (§ 734(b) basis adjustment). The FAQs clarify that a partner's tax basis capital account *is increased or decreased by a partner's share of basis adjustments under § 743(b) and § 734(b).* In contrast, according to the FAQs, *revaluations of partnership property* pursuant to § 704 (such as upon the entry of a new partner) *do not affect the tax basis of partnership property or a partner's tax basis capital account*.

Examples. The FAQs provide the following examples of the calculation of a partner's tax basis capital account:

> *Example 1:* A contributes $100 in cash and B contributes unencumbered, nondepreciable property with a fair market value (FMV) of $100 and an adjusted tax basis of $30 to newly formed Partnership AB. A's initial tax basis capital account is $100 and B's initial tax basis capital account is $30.
>
> *Example 2:* The facts are the same as in Example 1, except B contributes nondepreciable property with a FMV of $100, an adjusted tax basis of $30, and subject to a liability of $20. B's initial tax basis capital account is $10 ($30 adjusted tax basis of property contributed, less the $20 liability to which the property was subject).
>
> *Example 3:* The facts are the same as in Example 1, except in Year 1, the partnership earns $100 of taxable income and $50 of tax-exempt income. A and B are each allocated $50 of the taxable income and $25 of the tax-exempt income by the partnership. At the end of Year 1, A's tax basis capital account is increased by $75, to $175, and B's tax basis capital account is increased by $75, to $105.

Example 4: The facts are the same as in Example 3. Additionally, in Year 2, the partnership has $30 of taxable loss and $20 of expenditures which are not deductible in computing partnership taxable income and which are not capital expenditures. A and B are each allocated $15 of the taxable loss and $10 of the expenditures which are not deductible in computing partnership taxable income and which are not capital expenditures. At the end of Year 2, A's tax basis capital account is decreased by $25, to $150, and B's tax basis capital account is decreased by $25, to $80.

Example 5: On January 1, 2019, A and B each contribute $100 in cash to a newly formed partnership. On the same day, the partnership borrows $800 and purchases Asset X, qualified property for purposes of §168(k), for $1,000. Assume that the partnership properly allocates the $800 liability equally to A and B under §752. Immediately after the partnership acquires Asset X, both A and B have tax basis capital accounts of $100 and outside bases of $500 ($100 cash contributed, plus $400 share of partnership liabilities under §752). In 2019, the partnership recognizes $1,000 of tax depreciation under §168(k) with respect to Asset X; the partnership allocates $500 of the tax depreciation to A and $500 of the tax depreciation to B. On December 31, 2019, A and B both have tax basis capital accounts of negative $400 ($100 cash contributed, less $500 share of tax depreciation) and outside bases of zero ($100 cash contributed, plus $400 share of partnership liabilities under § 752, and less $500 of share tax depreciation).

Tax Basis Capital Account of a Partner Who Acquires the Partnership Interest from Another Partner. A partner who acquires a partnership interest from another partner, such as by purchase or in a non-recognition transaction, has a tax basis capital account immediately after the transfer equal to the transferring partner's tax basis capital account immediately before the transfer with respect to the portion of the interest transferred. However, any § 743(b) basis adjustment the transferring partner may have is not transferred to the acquiring partner. Instead, if the partnership has a §754 election in effect, the tax basis capital account of the acquiring partner is increased or decreased by the positive or negative adjustment to the tax basis of partnership property under §743(b) as a result of the transfer.

Safe Harbor Method for Determining a Partner's Tax Basis Capital Account. The FAQs provide a safe harbor method for determining a partner's tax basis capital account. Under this method, "[p]artnerships may calculate a partner's tax basis capital account by subtracting the partner's share of partnership liabilities under § 752 from the partner's outside basis (safe harbor approach). If a partnership elects to use the safe harbor approach, the partnership must report the negative tax basis capital account information as equal to the excess, if any, of the partner's share of partnership liabilities under § 752 over the partner's outside basis."

Certain partnerships are exempt from reporting negative tax basis capital accounts. Partnerships that satisfy four conditions (those provided in question 4 on Schedule B to Form 1065) do not have to comply with the requirement to report negative tax basis capital account information. This is because a partnership that satisfies these conditions is not required to complete item L on Schedule K-1. The four conditions are: **(1)** the partnership's total receipts for the tax year were less than $250,000; **(2)** the partnership's total assets at the end of the tax year were less than $1 million; **(3)** Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return; and **(4)** the partnership is not filing and is not required to file Schedule M-3.

b. The IRS has issued a draft of revised Form 1065 and Schedule K-1 for 2019. IR-2019-160 (9/30/19). The IRS has issued a draft of the partnership tax return, Form 1065, and accompanying Schedule K-1 for 2019. The IRS has also released draft instructions for the 2019 Form 1065 and draft instructions for the 2019 Schedule K-1. Compared to the 2018 versions, the 2019 versions reflect several significant changes that likely will require a substantial amount of time in many cases on the part of those preparing the return to ensure compliance. Among the significant changes are the following:

- *Reporting of tax basis capital accounts for each partner on Schedule K-1*. Previous versions of Schedule K-1 gave partnerships the option to report a partner's capital accounts on a tax basis, in accordance with GAAP, as § 704(b) book capital accounts, or on some "other" basis. Tax basis capital accounts were required beginning in 2018 only if a partner's tax capital account at the beginning or end of the year was negative. The 2019 draft Schedule K-1 requires partnerships to report each partner's capital account on a tax basis regardless of whether the account is negative. For partnerships that have not historically reported tax basis capital accounts, this requirement would appear to involve recalculating tax capital accounts in prior years and rolling them forward.

- *Reporting a partner's share of net unrecognized § 704(c) gain or loss on Schedule K-1.* Previous versions of Schedule K-1 required reporting whether a partner had contributed property with a built-in gain or built-in loss in the year of contribution. The 2019 draft Schedule K-1 still requires partnerships to report whether a partner contributed property with a built-in gain or loss, but adds new item N in Part II, which requires reporting the "Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)." This means that a partnership must report on an annual basis any unrecognized gain or loss that would be allocated to the partner under § 704(c) (if the partnership were to sell its assets) as a result of either the partner contributing property with a fair market value that differs from its adjusted basis or the revaluation of partnership property (such as a revaluation occurring upon the admission of a new partner).
- *Separation of guaranteed payments for capital and services.* Previous versions of Schedule K-1 required reporting a single category of guaranteed payments to a partner. The 2019 draft Schedule K-1 refines this category in item 4 of Part III and requires separate reporting of guaranteed payments for services, guaranteed payments for capital, and the total of these two categories.
- *Reporting on Schedule K-1 more than one activity for purposes of the at risk and passive activity loss rules.* Items 21 and 22 have been added to Part III of Schedule K-1 to require the partnership to check a box if the partnership has more than one activity for purposes of the at-risk or passive activity loss rules. The 2019 draft instructions for Form 1065 indicate that the partnership also must provide an attached statement for each activity with detailed information for each activity to allow the partner to apply correctly the at-risk and passive activity loss rules.
- *Section 199A deduction moved to supplemental statement.* The 2018 version of Schedule K-1 required reporting information relevant to the partner's § 199A deduction in item 20 of Part III with specific codes. The draft 2019 instructions for Form 1065 provide that, for partners receiving information relevant to their § 199A deduction, only code Z should be used in box 20 along with an asterisk and STMT to indicate that the information appears on an attached statement. According to the instructions, among other items, the statement must include the partner's distributive share of: (1) qualified items of income, gain, deduction, and loss; (2) W-2 wages; (3) unadjusted basis immediately after acquisition of qualified property; (4) qualified publicly traded partnership items; and (5) § 199A dividends (qualified REIT dividends). The statement also must report whether any of the partnership's trades or businesses are specified service trades or businesses and identify any trades or businesses that are aggregated.
- *Disregarded entity as a new category of partner on Schedule K-1.* Previous versions of Schedule K-1 required the partnership to indicate whether the partner was domestic or foreign. The 2019 draft Schedule K-1 adds a new category in item H of Part II in which the partnership must indicate whether the partner is a disregarded entity and, if so, the partner's taxpayer identification number and type of entity.

c. The IRS has postponed the requirements to use tax basis capital accounts for Schedule K-1 and to report detailed information for purposes of the at-risk rules and has clarified certain other reporting requirements. Notice 2019-66, 2019-52 I.R.B. 1509 (12/9/19). In response to comments expressing concern that those required to file Form 1065 and Schedule K-1 might be unable to comply in a timely manner with the requirement to report capital accounts on a tax basis for 2019, the Treasury Department and the IRS have deferred this requirement, which will now apply to partnership tax years beginning on and after January 1, 2020. According to the notice:

> This means that partnerships and other persons may continue to report partner capital accounts on Forms 1065, Schedule K-1, Item L, or 8865, Schedule K-1, Item F, using any method available in 2018 (tax basis, Section 704(b), GAAP, or any other method) for 2019. These partnerships and other persons must include a statement identifying the method upon which a partner's capital account is reported.

The requirement to report capital accounts for 2019 using any method available in 2018 includes the requirement that partnerships that do not report tax basis capital accounts to partners must report, on line 20 of Schedule K-1 (Form 1065) using code AH, the amount of a partner's tax basis capital both at the beginning of the year and at the end of the year if either amount is negative.

The draft 2019 Schedule K-1 included Items 21 and 22 in Part III to require the partnership to check a box if the partnership has more than one activity for purposes of the at-risk or passive activity loss rules. The 2019 draft instructions for Form 1065 also required a partnership to provide an attached statement for each activity with detailed information for each activity to allow the partner to apply correctly the at-risk and passive activity loss rules. In response to comments expressing concern that those required to file Form 1065 and Schedule K-1 might be unable to comply in a timely manner with the requirement to provide this detailed information in an attached statement, the notice defers this requirement. This requirement now will apply to partnership tax years beginning on and after January 1, 2020. The notice leaves in place for 2019 the requirement that a box be checked in Items 21 and 22 in Part III of Schedule K-1 if the partnership has more than one activity for purposes of the at-risk or passive activity loss rules.

The notice leaves in place for 2019 the requirement that a partnership must report on an annual basis a partner's share of "net unrecognized Section 704(c) gain or loss." The draft 2019 instructions for Schedule K-1, however, had not defined the term "net unrecognized Section 704(c) gain or loss." The notice defines this term as "the partner's share of the net (net means aggregate or sum) of all unrecognized gains or losses under section 704(c) of the Code (Section 704(c)) in partnership property, including Section 704(c) gains and losses arising from revaluations of partnership property." This definition applies solely for purposes of completing 2019 forms. The notice clarifies that publicly traded partnerships need not report net unrecognized § 704(c) gain for 2019 and future years until further notice. The notice also indicates that commenters had requested additional guidance on § 704(c) computations, especially on issues such as those addressed in Notice 2009-70, 2009-34 I.R.B. 255, which solicited comments on the rules relating to the creation and maintenance of multiple layers of forward and reverse section § 704(c) gain and loss to partnerships and tiered partnerships. Notice 2019-66 provides that, "[f]or purposes of reporting for 2019, partnerships and other persons should generally resolve these issues in a reasonable manner, consistent with prior years' practice for purposes of applying Section 704(c) to partners."

The notice provides that taxpayers who follow the provisions of the notice will not be subject to any penalty for reporting in accordance with the guidance it provides.

d. The Service has proposed two exclusive methods for satisfying the requirement to report tax basis capital accounts for partnership taxable years ending on or after December 31, 2020, and has asked for comments. Notice 2020-43, 2020-27 I.R.B. 1 (6/5/20). In this notice, the IRS has proposed a requirement that partnerships use only one of two exclusive methods for reporting a partner's tax capital account that would apply to partnership taxable years that end on or after December 31, 2020. Pursuant to the proposed requirement, partnerships would no longer be permitted to report partner capital accounts using any other method, including reporting capital accounts in accordance with GAAP or as § 704(b) book capital accounts. The notice indicates that comments received in response to the notice "will help inform the development of the instructions to be included in Form 1065 ... for taxable year 2020."

Background. According to the notice, commenters have indicated that they determine tax basis capital accounts using what the notice refers to as a "Transactional Approach." It appears that this approach is analogous to the method for determining a partner's book capital account prescribed in the regulations regarding the substantial economic effect requirement of § 704(b), except that the adjusted basis of property is used instead of the property's fair market value. Under this Transactional

Appproach, a partner's tax capital account is (1) increased by the amount of money and the adjusted basis of property contributed by a partner (less any liabilities assumed by the partnership or to which the property is subject) and by allocations to the partner of partnership income or gain, and (2) decreased by the amount of money and the adjusted basis of property distributed to the partner (less any liabilities assumed by the partner or to which the distributed property is subject) and by allocations to the partner of partnership loss or deduction. The notice indicates that Treasury and the IRS understand that partnerships using the Transactional Approach may not have been adjusting partner tax capital accounts in the same way under similar fact patterns. Further, issuing detailed guidance to promote consistent application of the Transactional Approach, according to some commenters, would be a major project that would consume significant IRS resources. Accordingly, the notice rejects a Transactional Approach to determining tax capital accounts and indicates that tax capital accounts determined in this manner will not satisfy the requirement to report partner tax capital accounts. Instead, the notice prescribes two alternative proposed methods for determining a partner's tax capital account: (1) the "Modified Outside Basis Method," and (2) the "Modified Previously Taxed Capital Method." These methods are discussed below.

Modified Outside Basis Method. The notice indicates that a partnership using this method to determine a partner's tax capital account must determine, or be provided by the partner, the partner's adjusted basis in the partnership interest (determined under the principles and provisions of subchapter K, including §§ 705, 722, 733, and 742) and subtract from it the partner's share of partnership liabilities under § 752. (This method was described as a safe harbor approach in the FAQs discussed above, which appear on the IRS website.) If the partnership is using this method, a partner must notify the partnership in writing of changes to the partner's basis in the partnership during the year other than those attributable to contributions by the partner, distributions to the partner, and allocations to the partner of income, gain, loss or deduction that are reflected on the partnership's Schedule K-1. An example of a situation in which notification to the partnership would be required is if a person purchases a partnership interest. A partnership using the Modified Outside Basis Method is entitled to rely on information provided by partners regarding their basis in partnership interests unless the partnership has knowledge of facts indicating that the information is clearly erroneous.

Modified Previously Taxed Capital Method. This method is a modified version of the method prescribed in Reg. § 1.743-1(d). The method prescribed in this regulation is used in determining the adjustments to the basis of partnership property under § 743(b) when a person purchases a partnership interest and the partnership has in effect a § 754 election. One adjustment is to increase the adjusted basis of partnership property by the excess of the purchasing partner's basis in the partnership interest over the partner's *proportionate share of the adjusted basis of partnership property*. A partner's proportionate share of the adjusted basis of partnership property is the purchasing partner's *interest as a partner in the partnership's previously taxed capital*, plus his or her share of partnership liabilities. In essence, the method prescribed in Reg. § 1.743-1(d) determines the partner's interest in the partnership's previously taxed capital (i.e., tax capital account) by first determining the partner's share of total capital and then backing out the portion that has not yet been taxed. Specifically, Reg. § 1.743-1(d) provides that a partner's share of previously taxed capital is determined by performing a hypothetical disposition by the partnership of all of its assets in a fully taxable transaction for cash equal to the *fair market value of the assets* and ascertaining:

1. The amount of cash the partner would receive on a liquidation following the hypothetical disposition of assets, increased by
2. The amount of tax loss that would be allocated to the partner from the hypothetical disposition of assets, and decreased by
3. The amount of tax gain that would be allocated to the partner from the hypothetical disposition of assets.

The notice modifies this method in two ways. *First*, it modifies the hypothetical disposition of assets to permit partnerships to use the fair market of assets if the fair market value is readily available or, alternatively, the bases of assets determined under § 704(b) (i.e., § 704(b) book basis), GAAP, "or the basis set forth in the partnership agreement for purposes of determining what each partner would receive if the partnership were to liquidate, as determined by partnership management." *Second*, for purposes of the second and third parts of the method set forth (allocation of tax loss and gain), the notice provides that all partnership liabilities are treated as nonrecourse "to avoid the burden of having to characterize the underlying debt and to simplify the computation." Partnerships that use the Modified Previously Taxed Capital Method will be required, for each year that the method is used, to attach to the partnership tax return a statement indicating that the Modified Previously Taxed Capital Method is used and the method used to determine the partnership's net liquidity value (such as fair market value, § 704(b) book basis, or GAAP).

Consistency and Change of Methods. The notice indicates that, whichever of the two methods the partnership uses, it must use the same method with respect to all partners. The first year for which the requirement to use one of these two methods to determine tax capital accounts will apply is 2020. For taxable years after 2020, the partnership can change methods by attaching a disclosure to each Schedule K-1 that describes the change (if any) to the amount attributable to each partner's beginning and end-of-year balances and the reason for the change.

Request for Comments. The IRS has requested comments, due by August 4, 2020, on the following five topics:

1. Whether the two proposed exclusive methods described above for determining tax capital accounts should be modified or adopted;
2. Whether, in connection with the hypothetical disposition of assets required as part of the Modified Previously Taxed Capital Method, an ordering rule should apply to the value used in the hypothetical disposition, e.g., use of fair market value might be required if readily available, and if it is not readily available, then § 704(b) book basis might be required unless the partnership does not maintain book capital accounts in accordance with § 704(b), in which case GAAP would be required;
3. How, if at all, the requirement to report tax capital accounts should be modified to apply to publicly traded partnerships;
4. Whether a Transactional Approach to determining tax capital accounts should be permitted and what additional guidance would be necessary to permit this approach; and
5. Whether (and in what circumstances) limitations should be imposed on partnerships to change from one method of determining tax capital accounts to another, including how partnerships would comply with such limitations in the case of the merger of partnerships using different methods.

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

F. Liens and Collections

G. Innocent Spouse

H. Miscellaneous

1. Tax Court retains jurisdiction in a § 7345 passport revocation case to review IRS's certification of taxpayer's "seriously delinquent" tax liability but finds case is moot. Ruesch

v. Commissioner, 154 T.C. No. 13 (6/25/20). Section 7345, which addresses the revocation or denial of passports for serioulsy delinquent tax debts, was enacted in 2015 as section 32101(a) of the Fixing America's Surface Transportation Act, Pub. L. 114-94 (Dec. 4, 2015). It provides that, if the IRS certifies that an individual has a "seriously delinquent tax debt," the Secretary of the Treasury must notify the Secretary of State "for action with respect to denial, revocation, or limitation of a passport." § 7345(a). In general, a seriously delinquent tax debt is an unpaid tax liability in excess of $50,000 for which a lien or levy has been imposed. § 7345(b)(1). A taxpayer who seeks to challenge such certification may petition the Tax Court to determine if it was made erroneously. § 7345(e)(1). If the Tax Court finds the certification was either made in error or that the IRS has since reversed its certification, the court may then notify the State Department that the revocation of the taxpayer's passport should be cancelled. § 7345(c). This is a case of first impression in which the Tax Court interprets the requirements of § 7345. The Tax Court (Judge Lauber) held that, while the Tax Court had jurisdiction to review Ms. Ruesch's challenge to the IRS's certification of her tax liabilities as being a "seriously delinquent tax debt," the controversy was moot because the IRS had reversed its certification as being erroneous. Further, the IRS had properly notified the Secretary of State of its reversal. The IRS had assessed $160,000 in penalties for failing to file proper information returns for a period of years. *See* § 6038. Thereafter, the IRS sent a final notice of intent to levy and Ms. Ruesch properly appealed the penalty amounts with the IRS's Collection Appeals Program (CAP). In a series of errors, the IRS mistakenly misclassified the CAP appeal as a Collection Due Process (CDP) hearing. Committing yet further errors, the IRS failed to properly record Ms. Ruesch's later request for a CDP hearing and never offered Ms. Ruesch her CDP hearing. The IRS then certified Ms. Ruesch's liability to the Secretary of State as a "seriously delinquent tax debt" under § 7345(b). Discovering their many errors as well as the oversight of Ms. Ruesch's timely requested a CDP hearing, the IRS determined her tax debt was not "seriously delinquent" and reversed the certification. Because, under § 7345, the Tax Court's jurisdiction in passport revocation cases is limited to reviewing the IRS's certification of the taxpayer's liabilities as "seriously delinquent," the only relief the Tax Court may grant is to issue an order to the IRS to notify the Secretary of State that the IRS's certification was in error. Since the IRS had already notified the Secretary of State of the error, the Tax Court could not offer any additional relief. Judge Lauber, therefore, found the controversy was not ripe to be heard and the issues were moot.

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

A. Enacted

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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

I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

A. <u>Income</u>

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

C. <u>Reasonable Compensation</u>

D. <u>Miscellaneous Deductions</u>

1. Rats! We knew that we should have been architects or engineers instead of tax advisors. The 2017 Tax Cuts and Jobs Act, § 11011, added § 199A, thereby creating an unprecedented, new deduction for trade or business (and certain other) income earned by sole proprietors, partners of partnerships (including members of LLCs taxed as partnerships or as sole proprietorships), and shareholders of S corporations. The Consolidated Appropriations Act, 2018, Pub. L. No. 115-141, Division T, § 101 ("CAA 2018"), signed by the President on March 23, 2018, amended § 199A principally to address issues related to agricultural or horticultural cooperatives. New § 199A is intended to put owners of flow-through entities (but also including sole proprietorships) on par with C corporations that will benefit from the new reduced 21% corporate tax rate; however, in our view, the new provision actually makes many flow-through businesses even more tax-favored than they were under pre-TCJA law.

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

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

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

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

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

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

Qualified business income—§ 199A(c). One component of the § 199A deduction is 20 percent of the taxpayer's qualified business income, which is generally defined as the net amount from a qualified trade or business of items of income, gain, deduction, and loss included or allowed in determining taxable income. Excluded from the definition are: (1) income not effectively connected with the conduct of a trade or business in the United States, (2) specified investment-related items of income, gain, deduction, or loss, (3) amounts paid to an S corporation shareholder that are reasonable compensation, (4) guaranteed payments to a partner for services, (5) to the extent provided in regulations, payments to a partner for services rendered other than in the partner's capacity as a partner, and (6) qualified REIT dividends or qualified publicly traded partnership income (because these two categories are separate components of the § 199A deduction).

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

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

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

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

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

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

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

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

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

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

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

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

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

c. The IRS has provided a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for purposes of § 199A. Rev. Proc. 2019-38, 2019-42 I.R.B. 942 (9/24/19). Whether a rental real estate activity constitutes a trade or business for federal tax purposes has long been an area of uncertainty, and the significance of this uncertainty has been heightened by Congress's enactment of § 199A. To help mitigate this uncertainty, the IRS has issued this revenue procedure to provide a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for purposes of § 199A and the regulations issued under that provision. (The revenue procedure is the final version of a proposed revenue procedure set forth in Notice 2019-7, 2019-9 I.R.B. 740 (1/18/19).) If a rental real estate enterprise does not fall within the safe harbor, it can still be treated as a trade or business if it otherwise meets the definition of trade or business in Reg. § 1.199A-1(b)(14). The revenue procedure defines a "rental real estate enterprise" as "an interest in real property held for the production of rents [that] may consist of an interest in a single property or interests in multiple properties." Those relying on the revenue procedure must hold the interest directly or through a diregarded entity and must either treat each property held for the production of rents as a separate enterprise or treat all similar properties held for the production of rents (with certain exceptions) as a single enterprise. Commercial and residential real estate cannot be part of the same enterprise. Taxpayers that choose to treat similar properties as a single enterprise must continue to do so (including with respect to newly acquired similar properties) when the taxpayer continues to rely on the safe harbor, but a taxpayer that treats similar properties as separate enterprises can choose to treat similar properties as a single enterprise in future years. For a rental real estate enterprise to fall within the safe harbor, the following four requirements must be met:

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

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

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

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

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

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

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

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

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

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

> **Example 1:** A self-employed CPA travels out of town to perform an audit. The CPA flies to the client's location and stays at a hotel for several days. While there, the CPA buys breakfast, lunch, and dinner each day. The meals are not "entertainment" and therefore are not subject to disallowance under amended § 274(a). They are, however, subject to the 50 percent limitation of § 274(n)(1).
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> **Example 2:** A self-employed attorney invites a client to attend a professional sports game and pays the entire cost associated with attending. The cost of attending will be regarded as entertainment and therefore not deductible.
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> **Example 3:** The client of a self-employed attorney spends the day in the attorney's office to review strategy for an upcoming IRS Appeals conference. They take a break for lunch at a restaurant down the street. During lunch, they continue their discussion.

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

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

Example 1.

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

Example 2.

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

Example 3.

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

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

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

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

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

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

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

E. Depreciation & Amortization

F. Credits

G. Natural Resources Deductions & Credits

H. Loss Transactions, Bad Debts, and NOLs

I. At-Risk and Passive Activity Losses

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

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

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

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

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

B. Interest, Dividends, and Other Current Income

C. Profit-Seeking Individual Deductions

D. Section 121

E. Section 1031

F. Section 1033

G. Section 1035

H. Miscellaneous

IV. COMPENSATION ISSUES

A. Fringe Benefits

B. Qualified Deferred Compensation Plans

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

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

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

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

D. Individual Retirement Accounts

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

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

C. <u>Hobby Losses and § 280A Home Office and Vacation Homes</u>

D. <u>Deductions and Credits for Personal Expenses</u>

E. <u>Divorce Tax Issues</u>

F. <u>Education</u>

G. <u>Alternative Minimum Tax</u>

VI. CORPORATIONS

VII. PARTNERSHIPS

A. <u>Formation and Taxable Years</u>

B. <u>Allocations of Distributive Share, Partnership Debt, and Outside Basis</u>

C. <u>Distributions and Transactions Between the Partnership and Partners</u>

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

E. <u>Inside Basis Adjustments</u>

F. <u>Partnership Audit Rules</u>

G. <u>Miscellaneous</u>

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. <u>Exempt Organizations</u>

B. <u>Charitable Giving</u>

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

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

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

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

F. Liens and Collections

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

G. Innocent Spouse

H. Miscellaneous

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

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

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

A. <u>Enacted</u>

New Proposed Carried Interest Regulations

Implications to the Private Equity Energy Industry

September 22, 2020

Brandon L. Bloom

ThompsonKnight

Overview

- **Section 1061**
  - 2017 Tax Cuts and Jobs Act added Section 1061 which increased long-term capital gain holding period for partnership interests that qualify as carried interests from one to three years
  - A "carried interest" is an interest in private equity or hedge fund profits held by fund mangers in exchange for services

TK

Overview

- Proposed Regulations
  - Advanced copy released July 31, 2020 (REG-107213-18); published in Federal Register on August 14, 2020
  - Left some gaps and areas of uncertainty
  - Generally effective after final regulations are published
  - May rely on proposed regulations if applied in entirety and consistently

TK

Section 1061: API

- Gain allocated to an applicable partnership interests (“API”) held in connection with the performance of certain services will be recharacterized as short-term capital gain unless held for three years
- API
  1. Partnership interest held (directly or indirectly) by, or transferred to, a taxpayer
  2. In connection with the performance of substantial services by the taxpayer or a related person
  3. In an applicable trade or business (“ATB”)
- API does not include:
  - Partnership interest held by a corporation
  - Capital interest in a partnership
  - Partnership interest held by employee of non-ATB entity

TK

Section 1061: ATB

- ATB
  - Activity conducted on a regular, continuous, and substantial basis through one or more entities whose activities consist of:
    1. Raising or returning capital
    2. Investing in, disposing of, or identifying specified assets or developing specified assets

TK

Section 1061: Specified Assets

- Specified Assets
  - Securities
  - Commodities
  - Real estate held for rental or investment
  - Cash or cash equivalents
  - Options or derivative contracts
  - Interest in partnership holding such assets

Section 1061: Related Person Transfer

- Transfer (directly or indirectly) of an API to a "related person" accelerates short term capital gain recognition (even if the transfer would otherwise not be taxable) assuming a sale of all underlying assets
- Related person
  - family member
  - colleague who performed a service within the current calendar year or preceding three calendar years in any ATB that taxpayer performed services for
  - pass-through entities to the extent family member or colleague is an owner

TK

Proposed Regulations: Overview

- API and ATB Definitions
- Exceptions
- Holding Period
- Tiered Partnerships
- In-Kind Distributions
- Related Person Transfers
- Carried Interest Waivers
- Reporting Requirements

Proposed Regulations: API and ATB Definitions

- API
  - Broad definition
  - API remains an API unless and until an exception applies
  - Substantial services presumption
- ATB
  - Activities (*e.g.*, raising or returning capital and investing or developing) do not have to occur in the same year
  - Activities of related persons are aggregated

TK

Proposed Regulations: API and ATB Definitions

- *Open Items:*
  - What activities constitute ATB (investment v. business activities)?
    - Hardware store example
  - Aggregating activities of all businesses managed by same management co.?
  - "Commodity" specified assets include trading in oil and gas?

TK

Proposed Regulations: Exceptions

- Non-ATB Employee Exception
- Corporation Exception
- Capital Interest Exception
- Bona Fide Purchaser Exception
- Section 1061(b)/Family Office Exception
- Excluded Income and Gains

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Proposed Regulations: Exceptions

- Non-ATB Employee Exception
  - Consistent with statute
  - An API does not include any interest held by a person conducting services and employed by an entity not engaged in an ATB
  - May apply if a portfolio company employee received a profits interest in the investor private equity fund

Proposed Regulations: Exceptions

- Corporation Exception
  - Does not include an S corporation
  - Consistent with IRS Notice 2018-18
  - S corporation rule effective December 31, 2017
  - Does not include a passive foreign investment company (PFIC) with qualified electing fund (QEF) election
- *Open Items*:
  - Treasury/IRS authority?
  - Congressional action?

TK

Proposed Regulations: Exceptions

- Capital Interest Exception
  - Narrowly defined and applied
  - Service provider's rights must track non-service provider rights
  - Allocations must be proportionate to value of contributed capital
  - Clearly identify allocations to API-holder and 3rd party non-service providers
  - 3rd party non-service providers must hold 5% or more
  - Contributed capital does not include borrowed or guaranteed amounts

Proposed Regulations: Exceptions

- *Open Items:*
  - Comments on allocation rules
  - Unpromoted capital (does exception apply to portion that would otherwise be carry?)
  - Allocations made on pro rata basis with investors attributable to unrealized book gain
  - Treasury authority for borrowing exclusion?

Proposed Regulations: Exceptions

- Bona Fide Purchaser Exception
  - New exception
  - Excludes an API acquired by an unrelated bona fide purchaser for fair market value who does not perform and has never performed services directly or indirectly in the ATB

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Proposed Regulations: Exceptions

- Section 1061(b)/Family Office Exception
  - Statute authorizes Treasury to create exception for gain attributable to any assets not held for portfolio investment on behalf of third-party investors
  - Reserve on further rule making
  - Already implemented into exception rules

- *Open Items:*
  - Explicit rules for family offices

Proposed Regulations: Exceptions

- Excluded Income and Gains
  - Three year holding period applies only to capital gains that would be treated as long-term capital gains pursuant to Sections 1222(3) & (4)
  - Other gains and losses are not subject to recharacterization under section 1061:
    - Section 1231 gain or loss on property used in trade or business
      - Impacts decision to sell assets v. entity interests
    - Market-to-market gains from certain futures and options contracts
    - Qualified dividend income
    - Capital gains and losses characterized without regard to asset's holding period
- *Open Items:*
  - Gain attributable to self-created goodwill?

TK

Proposed Regulations: Holding Period

- Relevant holding period is the holding period of person disposing of asset rather than API holder's holding period
- Look-through rule
  - If API held for more than three years is deposed of and 80% or more of value of partnership assets are held for three years or less, a percentage of API disposition gain or loss is treated as short term capital gain

Proposed Regulations: Tiered Partnerships

- API gains or losses retain their status as they move up through the tiers
- Only beneficial taxpayers aggregate API gains or losses (tiered pass-through entities do not)

Proposed Regulations: In-Kind Distributions

- Assets distributed in-kind and then disposed of (directly or indirectly) by API holder are eligible for long term capital gain only if three-year holding period requirement is satisfied
- "Tacking" rules apply

Proposed Regulations: Related Person Transfers

- Direct or indirect transfer of API or property distributed from API to related person generally triggers short-term capital gain
- "Transfer" includes nonrecognition transfers, contributions, distributions, sales and exchanges, and gifts
- Related person is family or colleague
- Excludes 721(a) contribution to partnership
- *Open Items*:
  - Exclude other nonrecognition transfers?

TK

Proposed Regulations: Carried Interest Waivers

- General Partner elects to waive or defer allocations and distributions of carried interest that have not been held for three years to avoid capital gain
- Are subject to anti-abuse and economic substance rules and may not be respected
- *Open item*:
  - No further guidance is provided

Proposed Regulations: Reporting Requirements

- Imposes reporting requirements on partnerships and partners with carried interests
- Failure to comply may result in unintended short term capital gain (presumption that 3 year holding period applies) and penalties

Questions?

?

Guidance issued regarding deductions of trusts and estates

May 08, 2020

On May 7, 2020, the Treasury released proposed regulations regarding the deductibility of certain excess deductions reported to beneficiaries on Schedule K-1 as well as formalized the guidance regarding the definition of miscellaneous itemized deductions for trusts and estates. These proposed regulations are retroactive to taxable years beginning after Dec. 31, 2017 and affect estates, non-grantor trusts and their beneficiaries.

Miscellaneous deductions for trusts and estates

The Tax Cuts and Jobs Act (TCJA) introduced section 67(g) to the tax code which prevented the deduction of miscellaneous itemized deductions for individual taxpayers as well as trusts and estates for taxable years beginning after Dec. 31, 2017. Section 67(e) provides that certain expenses which are paid or incurred in connection with the administration of the estate or trust, and which would not have been incurred if the property were not held in an estate or trust, are allowable in arriving at adjusted gross income (AGI). Questions arose regarding the deductibility of these expenses given the new TCJA suspension of miscellaneous itemized deductions defined in that same section.

On July 13, 2018, the IRS issued Notice 2018-61 announcing proposed regulations would be coming and would clarify that expenses under section 67(e) remain deductible in determining AGI. Additionally, the deduction for the personal exemption, the deduction for distributions made by trusts currently distributing income and the deduction for distributions made by trusts accumulating income continue to be allowed in determining AGI.

The proposed regulations modify existing regulations to clarify that expenses under section 67(e) remain deductible in determining AGI and are not subject to disallowance under section 67(g).

Excess deductions on termination of trusts and estates

Of more interest is the treatment of deductions in excess of income in the final year of a trust or estate. Often assets have been distributed across many years, so once a trust or estate arrives at its final reporting year, the income is less than the expenses incurred in the final year. This excess is typically referred to as "excess deductions on termination" under section 642(h)(2).

The TCJA enactment of section 67(g) resulted in confusion as to the tax treatment of excess deductions reported by trusts and estates to its beneficiaries in their final filing year. Prior to TCJA deductions in excess of the gross income (other than a net operating loss or a capital loss) were distributed to beneficiaries and deductible as miscellaneous itemized deductions. While TCJA did not affect the deductibility of the net operating loss and capital loss carryovers under 642(h)(1), the treatment of the excess deductions was unclear. Notice 2018-61 explained that the Treasury and IRS were studying whether some or all of these deductions should be deductible in the hands of the beneficiary, but provided no guidance.

Under the new proposed regulations, excess deductions under section 642(h) in the final year will be divided into three buckets:

- Amounts allowed in arriving at AGI
  - Ex. Net operating loss carryovers, capital loss carryovers, section 67(e) deductions
- Non-miscellaneous itemized deductions
  - Ex. Non-business state income tax and real estate tax
- Miscellaneous itemized deductions
  - Ex. Investment management fees

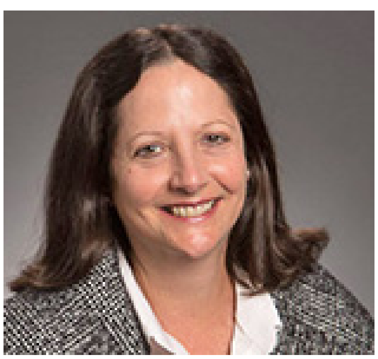
The deductions will retain their character in the hands of the beneficiary and the fiduciary must separately state the three classes of deductions which may be limited when claimed by the beneficiary. The proposed regulations follow the allocation rules under the section 652 regulations. Expenses directly attributable to one class of income must be allocated to that class of income. Expenses in excess of their specific class of income and expenses not directly attributable to one class of income will be allocable to any item of income, but a portion must be allocated to tax exempt income.

The proposed regulations also include new examples to illustrate the application of these new rules.

Takeaways

Fiduciaries and beneficiaries have the opportunity to amend 2018 and 2019 fiduciary and individual tax returns so that beneficiaries can claim the excess deductions on previously filed tax returns. The proposed regulations do not address the treatment of the investment interest expense carryover. The proposed regulations provide that an item of deduction succeeded to by a beneficiary remains subject to any additional applicable limitation.

AUTHORS



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The SECURE Act: The Pros, the Cons, and its Practical Application to Estate Planning + Lessons Learned in the Pandemic

Laurel Stephenson and Shannon Bonn, Davis Stephenson, PLLC, Dallas, Texas

SECURE Act – the "Headlines" Material

- Effective 1/1/2020
- Required Beginning Date (RBD) for Required Minimum Distributions (RMDs) now 4/1 after year Owner turns 72 (previously, 70.5)*
- No age limitation on IRA contributions (compensation cap)
  - IRA Qualified Charitable Distribution (QCD; still 70.5) offset by post-70.5 deductible IRA contributions
    - No QCD to private foundations, supporting organizations, DAFs
    - IRA contribution deduction may be limited (See IRC 219 for gross income and employer retirement plan participation limits, including spouse)

*Unless (i) 401(k) and still employed or (ii) Roth account

SECURE Act – the "Headline" for Estate Planners
Substantial Limitations on "Stretch" Planning

- Affected: Inherited IRA(s) (including Roths) and Defined Contribution Plans (not defined benefit plans)
- Prior law (post Owner's death): Benefits could be paid out over life expectancy (LE) of "designated beneficiary" (DB)
  - Defer payment of income tax (ordinary income)
  - Preserve tax-free growth
- Now: 10-year payout, with **few** exceptions
- Application: Generally, Owner dying after 2019
  - If pre-2020 death and DB (LE payout) dies post-2019, 10-year payout applies at DB death (how impact "accumulation" trust?)
- Overlay: New rules are an overlay of prior law

Prior Law/Sometimes Still the Law

- Generally: The universal caveat!
- DB: Individual or "see-through" trust (**unchanged**)
- Not a DB: Charity, estate, or trust not "see-through" (**unchanged**)
- If Beneficiary is not DB: (i) 5-year payout if Owner dies pre-RBD OR (ii) Owner's LE if death post-RBD (**unchanged**).
- If Beneficiary is DB other than Surviving Spouse: Longer of (i) Owner's LE if death post-RBD or (ii) DB's LE (if DB is see-through accumulation trust, oldest beneficiary's LE)
  - SECURE Act: 10-year payout replaces (ii), with Eligible Designated Beneficiary (EDB) exceptions; availability of (i) ***likely***.
  - At death of primary beneficiary?

Spousal Planning

- If DB is Spouse: Typically, elect treat IRA as own or roll over to own IRA
  - But first - YOD RMD still made based upon Owner's age
  - IRA election post-YOD year retroactive to 1/1, MRD (if any) based upon spouse as Owner rather than beneficiary (if rollover, as beneficiary, unless rollover in YOD)
  - "Owner" (own RBD, Uniform Life Table, annually recalculated LE)
- If DB is Conduit Trust for Spouse: RMDs: (i) Single Life Table, annual recalculated; (ii) first RMD due 12/31 post-YOD unless Owner died pre-RBD; (iii) if (ii), first RMD due 12/31 following Owner's 72nd birthday; and (iv) at death, 10-year payout (not Spouse's remaining LE, as previously case)
- If DB is Accumulation Trust for Surviving Spouse: 10-year payout (previously, Spouse's LE), unless Owner dies post-RBD and LE exceeds 10 years)

“See-Through” Trust

- Rules: Criteria unchanged by SECURE Act
- Effect: “Counted” beneficiaries treated as DBs of plan/IRA
  - Under SECURE Act, 10-year payout (exceptions: Conduit Trust for EDB or accumulation trust defined “Applicable Multi-Beneficiary Trust” (AMBT))
- Five Requirements of “See-Through” Trust:
  - Valid under local law
  - Irrevocable before or as of Owner’s death
  - Documentation to plan administrator by 10/31 following YOD
  - All beneficiaries must be individuals (excluding “mere potential successors”)
  - Beneficiaries must be “identifiable” (i.e., identify beneficiary with shortest life expectancy)

Types of “See-Through” Trusts

- Conduit Trust:
  - Current beneficiary considered sole beneficiary of trust and plan
  - Acquired funds immediately distributed to beneficiary
  - Post-SECURE Act, only an EDB qualifies for LE-payout (10-year payout at “majority” for Conduit Trust for Owner’s minor child)
  - Remainder beneficiary irrelevant (charities/estate for GST planning)
- Accumulation Trust:
  - Acquired funds may be retained in trust
  - Health, education, maintenance, support (HEMS) or pure discretion trust
  - Permits multiple individual beneficiaries (“mere potential successors” ignore; appointees under power of appointment may “count”)
  - Oldest “counted” beneficiary’s LE dictated payout **pre-SECURE**
  - Now, only AMBT receive LE-payout (disabled/chronically ill individuals)

RMDs Post-SECURE Act

- Definition of DB: No change
- Payout if no DB: No change
- Payout if DB Not "Eligible Designated Beneficiary" (EDB): Longer of (i) 10-year payout (**probably by** 12/31 of year of 10th anniversary of DOD) or (ii) Owner's remaining LE, if dies after RBD (**probably**)
- If DB is EDB: LE-payout during EDB qualification (10-year payout after EDB status ends, even if successor is an EDB)
  - EDB determined at Owner's death (unless child later becomes disabled/chronically ill pre-majority)
- No required annual distributions during 10-year term
  - Consider negatives of taxable income "bunching" for non-Roth IRAs
  - Roth IRAs likely benefit from no payments until year 10

<u>ELIGIBLE DESIGNATED BENEFICIARIES (EDBs)</u>

- <u>EDB #1: Spouse (Conduit Trust)</u>:
  - Single Life Table; annual recalculation of spouse's LE
  - If conduit trust, first RMD due later of (i) 12/31 year after DOD or (ii) 12/31 year when Owner would have turned 72
  - Better results with spousal election or spousal rollover
    - First RMD due 4/1 after year in which spouse turns 72
    - Uniform Life Table; annual recalculation of spouse's LE
  - Standard QTIP will not qualify as conduit trust

- <u>EDB #2: Owner's child who "has not reached majority</u>":
  - Note, only <u>Owner's</u> child
  - Defined: Age of majority (state law), unless not "completed a specified course of education" (IRC § 401(a)(9)(F); mean?), then sooner of completion or age 26
  - Minority status preserved if child later disabled (chronic illness?)
  - 10-year payout applies upon majority
  - Outright or conduit trust (concede LE, opt for accumulation trust?)
    - Conduit pot trust for minor children?
    - Conduit trust flip to accumulation trust at majority (unlikely)?

- If conduit trust, postpone total distribution of account until latest age 36 (LE-payout until 26, then 10-year payout)
- Useful exception?
  - Rare both parents die with minor children
  - Unlikely parents with minor children large retirement account
  - Child likely to need funds (e.g., college, new house, etc.)
  - Split between conduit and accumulation trusts?

- EDBs #3 and #4: Disabled or chronically ill individual
  - Determination: At Owner's death
    - Criteria?
      - Chronically ill: IRC § 7702(B)(c)(2)
      - Disabled: IRC § 72(m)(7)
      - Neither standard easily applies to minors ("gainful activity")
    - Certification Deadline: Likely 10/31 post YOD
    - EDB status forfeitable?
  - Receipt via AMBTs
    - Accumulation Trust ("see-through" trust)
    - Allows for multiple disabled or chronically ill current beneficiaries
    - LE for payout? For now, ensure EDB oldest "countable" beneficiary
    - Update special needs provisions

- EDB #5: Individual Not Described Above not more than 10 years younger than Owner:
  - Who: Typically, siblings or significant other (not spouse)
  - How: Outright or conduit trust
  - Why Trust:
    - Money management issues/lock in LE-payout
    - Marital issues
    - Estate tax concerns
  - Different approach for different individuals

At Death of DB or EDB?

- At death of DB not an EDB, payout within original 10-year period
- If EDB status is discontinued (e.g., child reaches majority or EDB dies), 10-year payout upon status discontinuation
  - Not EDB's remaining life expectancy
  - Successor beneficiary's EDB status is irrelevant

Effective Date

- Owner dying after 2019
- However, if Owner dies pre-2020 and DB w/LE-payout dies post-2019, 10-year payout at DB death
  - Impact "see-through" accumulation trust?   Each beneficiary is a DB w/oldest DB's LE the payout (pre-SECURE Act)
    - 10-year payout upon death of any DB? Oldest DB? Survivor DB?

<u>IMPACT OF SECURE ACT: OVERVIEW</u>

- <u>Practical Answer/Good news</u>: For many clients, minimal
  - <u>Spouse as Primary</u>: Still most tax favorable (rules changed at death)
  - <u>Adult Children as Secondary</u>: Typically opt for lump sum
    - Unlikely significant balance at surviving spouse's death
    - Likely have adult children
  - <u>Charity as Secondary</u>: Even better decision!
- <u>Critical exception</u>: Plan w/conduit trust (**<u>revisit</u>**; consider accumulation trust?)
- <u>Other recommended tweaks</u>:
  - Convert conventional QTIP (<u>old</u> rules, LE-payout) to conduit trust
  - Independent trustee of accumulation trust broad discretion avoid "HEMS" trap of taxable income
  - Update special needs trusts to ensure qualify as AMBT

<u>SECURE Act Impact: Conduit Trust</u>

- <u>Reminder</u>: Requires immediate distribution of withdrawn funds
- <u>Adaptability post SECURE Act</u>?
  - If requires "lifetime payout" and current beneficiary is non-EDB?
  - If requires withdrawal of "required minimum distribution" and non-EDB, result in lump sum/income "bunching" in year 10?
  - If Owner's minor child, same issues with 10-year payout

SECURE Act Impact: Conduit Trust (Cont'd)

- Future Usefulness?
  - Limited to EDBs
  - Income Taxation: DNI carryout
    - Promising EDB Candidates: Certain spouses (blended marriage, addiction/susceptibility issues), siblings, significant other
      - "Locked in" extended payout
      - Divorce protection/other creditors
      - Estate tax exposure
      - "Locked in" distribution of funds remaining at death
    - Less Promising EDB Candidates: Minor children
      - Smaller distributions during minority years when funds "needed"
      - Total distribution by age 36 *at latest*
      - Compromise with combination of both?
    - Not Good EDB Candidates: Disabled/chronically ill (have AMBT)

<u>**SECURE Act Impact: Accumulation Trust**</u>

- <u>Distributions</u>:
  - <u>Non-Special Needs</u>: Health, education, maintenance, support (HEMS)
  - <u>Special Needs/AMBT</u>: Total discretion w/"settlor's intent"
- <u>Protections</u>: Divorcing spouse, other creditors (distributed funds), estate taxes, governmental benefits preservation, "final taker" protection
- <u>Income Taxation (non-Roth)</u>: Retained income hits top rate at $13,000
- <u>Solutions for Non-Special Needs Trust (not Roth)</u>:
  - Avoid w/distribution and DNI carryout (why the trust? the unforeseen creditor or addiction?)
  - "Beneficiary Deemed-Owner Trust" (BDOT)
    - Taxable income (accounting income and taxable income allocable to principal) withdrawable by current beneficiary (limited period)
    - IRC § 678(a) taxation of trust taxable income at beneficiary's rates

- Withdrawn funds lose trust protections
- Taxable income not withdrawn
  - "5/5 Amount" (IRC § 2514) Lapse: No taxable gift or unintended estate inclusion; preserved creditor protection (Texas Trust Code 112.035)
  - Excess amount:
    - If lapsed, avoid completed gift by beneficiary to trust via power of appoint; will have estate inclusion; self-settled
    - Withdrawal right could "hang" until safe 5/5 lapse
    - Alternatively, withdraw excess (gift or purchase life insurance)
  - Upside:
    - Trust protections partially preserved
    - Income tax payment (IRC § 678) not gift to trust (Rev. Rul.2004-64)
  - Downside: "Messy" income tax reporting; "self-settled" portion

Takeaways?

- Charity:
  - Lifetime gifts
    - QCD (IRA only): Excludes private foundations, supporting organizations, community foundations
    - QCD Reduction (i.e., AGI inclusion): IRA owner's post-age 70.5 deductible IRA contributions
  - Testamentary gift
- Charitable Remainder Trust: Can "mimic" lifetime payout (need charitable intent; not workable for young beneficiaries)
- EDBs: Leave retirement assets to EDBs and other assets to non-EDBs?
  - Spouse as primary is a given

Takeaways (Cont'd)?

- Accumulation Trust: If only viable option (e.g., adult w/addiction):
  - Partial or total Roth conversion during Owner's lifetime if in lower bracket during conversion year (e.g., large charitable gift or charitable carryforward)
    - 10-payout applies to inherited Roth, so limited tax-free build up
    - Uncertainty of future tax rules
    - Income tax payment out of estate (no estate tax deduction for IRA's deferred income taxes)
  - Trustee with Appropriate Discretion:
    - "Sprinkle" power among multiple beneficiaries
    - Independent trustee with total discretion (no "HEMS" limits)
    - "Robust" facility of payment clause
- Overdue Clarity and Practicality from Treasury? Permit non-AMBT trust qualify for EDB status if EDB sole current beneficiary? What if EDB via more than one status?

Solutions for Existing Plans Negatively Impacted

- Best: Update trust documents and beneficiary designations
- Reformations: If irrevocable (but see PLR 200742026) but new era
- "Clean up" before 10/31 "Finalization Date"
  - Disclaimer by beneficiary not a DB

Example # 1: Non-DB

Facts: Trust not a "see-through" trust is beneficiary

- **Owner dies at age 68:**
  - **Pre-SECURE Act:** 5-year payout because Owner died before RBD (4/1 following year in which reach 70.5)
  - **Post-SECURE Act:** Same result (RBD is 4/1 following year in which reach 72)
- **Owner dies at age 72:**
  - **Pre-SECURE Act:** Payout based upon Owner's remaining LE because died post-RBD
  - **Post-SECURE Act:** 5-year payout because Owner died before RBD (4/1 following year in which reach 72)
- **Owner dies at age 75:**
  - **Pre-SECURE Act:** Payout over Owner's remaining LE
  - **Post-SECURE Act:** *Probably* same result

Example #2: Adult Daughter as Designated Beneficiary

Facts: Daughter primary beneficiary of IRA

- **Owner dies 2019 (Pre-SECURE)**: Daughter age 30 designates Granddaughter as successor beneficiary. Daughter dies in 2022.
  - Owner's death: Daughter is DB w/52.4-year LE-payout*
  - Daughter's death: Granddaughter has 10-year payout (by 12/31/2033)
  - Rule: If Owner dies pre-2020, post-2019 DB death triggers 10-year payout
- **Owner dies 2020** (Post-SECURE)**:** Daughter age 31 designates Granddaughter as successor beneficiary. Daughter dies in 2023.
  - Owner's death: Daughter is DB w/10-year payout (by 12/31/31)**
  - Daughter's death: Granddaughter deplete account by 12/31/31 even if disabled/chronically ill at both deaths (loss of 40+ deferral years)
  - Rule: If Owner dies post-2019 and DB under 10-year period, benefits paid out to DB's successor within ORIGINAL 10-year period

* Current Single Life Expectancy Table (new in 2021) using year after YOD

**If Owner died post-RBD, possibly Owner's remaining life expectancy, if longer

Example # 3

Conduit Trust for Minor Child of Owner as DB

Facts: Owner designates Son's Conduit Trust (DOB: 2/1/2011) as primary beneficiary of IRA

- Owner Dies 2019 **(Pre-SECURE)**: 73.8-year payout based upon Son's life expectancy (if $1M balance 12/31/19, first RMD $13,500)
- Owner DOD: 2020 (**SECURE Act Applies)**:
  - Son is EDB during minority (we *think* until age 26)
  - 72.8-year payout based upon LE (if $1M balance 12/31/20, first RMD $13,700)
  - Once Son 26 (2/1/2037), 10-year payout (12/31/2048)
  - Caveat, if Son becomes disabled (or we *think*, chronically ill) prior to majority, LE-payout preserved

Example # 4:

Conduit Trust for Grandchild as Designated Beneficiary

Facts: Owner names Conduit Trust for minor Grandson (DOB: 2/1/2011) as IRA beneficiary. Grandson not disabled/chronically ill.

- Owner dies 2019 when Grandson is 8 (**Pre-SECURE)**
  - 73.8-year payout based upon Grandson's life expectancy (if $1M balance 12/31/19, first RMD is $13,500)
- Owner dies 2020 when Grandson is 9 (Post-**SECURE)**
  - Conduit Trust is DB but Grandson's LE inconsequential unless disabled/chronically ill (if so, see above)
  - Grandson not EDB because not minor child of Owner
  - Trustee withdraw funds and distribute to Grandson by 12/31/31(Facility of payment clause available to mitigate in interim?)
  - Loss of 60+ years of deferral
  - Will receive in full at age 20 (vs. age 36 if minor child of Owner)

Example #5 - Qualified Charitable Distributions

Facts: Owner (age 72) directs $100,000 QCD from his IRA to charity; RMD $98,000

- No Deductible IRA Contribution: QCD entirely excluded from AGI and RMD “made”
- If $7,000 Deductible IRA Contribution Made Post 70.5: $7,000 of QCD includible in AGI; RMD “made”
- Note:
  - Age for RMDs increased from 70.5 to 72
  - Age for making a QCD (70.5) unchanged
  - Consequently, QCD starting at age 70.5 but not satisfy RMDs until after RBD (4/1 of year following turn 72)

Example # 6
<u>AMBT as DB</u>

<u>**Facts:**</u> Owner designates AMBT for Grandson as beneficiary of his IRA. Owner dies 01/01/2020, and Grandson (age 25) is then "disabled."*

- **If Pre-SECURE:**
  - 57.2-payout based upon Grandchild's LE
- **Post-SECURE Act:**
  - If trust is AMBT, Trustee may take distributions over Grandchild's life expectancy (57.2 years) until his death, at which point a 10-year payout applies

*By criteria ideally to be clarified in future guidance.

Takeaways

- Critical to revisit existing retirement planning, particularly if trust-focused
  - Clients' circumstances change?
    - Increased charitable interests?
    - Family dynamics changed (children older? addiction issues addressed?)
  - EDB strategic planning
- Consider strategic Roth conversion?
- Consider insurance as wealth replacement

Lessons Learned in the Pandemic

- Texas Remote Notarization Via Videoconference:
  - Rule: Specified estate planning documents; Governor-declared state-of-disaster proclamation for COVID-19 (30-day renewal)
  - Procedures:
    - Confirm identity w/government-issued identification w/photo and signature (e.g., passport or driver's license)
    - Notary observes signing
    - Signer sends signed document via fax/emailed scan; notary notarizes and transmits back to signer during videoconference
    - Recording not required for EP documents (good idea?)
    - Documents remain valid post-lifting of state-of-disaster
    - Which county reflected in notary block?
    - Revised notary text to reflect videoconference utilized?

Lessons Learned in the Pandemic (cont.)

- Remote Notarization Procedures (cont.):
  - Concerns:
    - Inevitable technology/implementation issues (double-sided)
    - Governor have authority?
    - Band-Aid; recommend later re-execution in person
  - For more information on Texas procedures, see **William D. Pargaman, A Guide to Executing Estate Planning Documents in Uncertain Times (2020)**.
  - For more information on procedures in other states, see https://www.actec.org/resources/emergency-remote-notarization-and-witnessing-orders/.

Lessons Learned in the Pandemic (cont.)

- Alternatives to Notarization/Required Witnesses
  - Self-Declaration via Texas Civil Practice and Remedies Code Sec. 132.001 provides that a written, unsworn declaration can be used in lieu of a written sworn declaration, verification, certification, oath, or affidavit required by statute or required by a rule, order, or requirement adopted as provided by law (signed under penalty of perjury; specific jurat)
    - Limited Use:
      - Certain stated exceptions, including oath of office
      - May not cover **acknowledgments** (Durable Powers of Attorney)
      - Inapplicable for self-proving affidavit (Texas Estates Code 21.005)
    - Confirmed Uses: Waivers of citation w/probate and trust reformations
    - Additional information, see **William D. Pargaman, A Guide to Executing Estate Planning Documents in Uncertain Times (2020)**.
- Holographic Codicils: Simple updates; re-execute post-pandemic

Lessons Learned in the Pandemic (cont.)

- Lessons With Prospective Potential: Add flexibility to documents
  - Remove Unnecessary Notarization Requirements
    - Trust instruments/amendments
    - Exercises of powers of appointment
    - Other administrative tasks under the trust
  - Remove Unnecessary Formalities of Notice Delivery
    - Eliminate certified mail delivery, where appropriate
    - Expressly permit electronic mail and text notices
  - Use revocable trust as “will substitute”

TAX SECTION
State Bar of Texas

October 5, 2020

Via Federal eRulemaking Portal at *www.regulations.gov*

Internal Revenue Service
CC:PA:LPD:PR (REG-107213-18)

RE: ***Comments Regarding Proposed Regulations under Section 1061***

Ladies and Gentlemen:

On behalf of the Tax Section of the State Bar of Texas ("Tax Section"), I am pleased to submit the enclosed response to the request of the United States Department of the Treasury (the "Treasury Department") and the Internal Revenue Service (the "Service") for comments pertaining to proposed regulations, appearing in the Notice of Proposed Rulemaking (REG-107213-18) issued on July 31, 2020 (the "Proposed Regulations"), under Section 1061 of the Internal Revenue Code of 1986, as amended (the "Code").

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Treasury Department and the Service for the time and thought that have been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Lora G. Davis

Lora G. Davis, Chair
State Bar of Texas, Tax Section

Enclosure

COMMENTS ON PROPOSED REGULATIONS
UNDER SECTION 1061

These comments on the Proposed Regulations ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Lee S. Meyercord and Nathan T. Smithson, Co-Chairs of the Partnership and Real Estate Tax Committee of the Tax Section of the State Bar of Texas, Andrew E. Botts, Brandon L. Bloom, Todd Lowther, Julia Pashin, and Jeff Wallace, members of the Partnership and Real Estate Tax Committee of the Tax Section of the State Bar of Texas, and Carol G. Warley, Chair of the Estate and Gift Tax Committee of the Tax Section of the State Bar of Texas. The Committee on Government Submissions of the Tax Section has approved these Comments. Mary A. McNulty, past Chair of the Tax Section of the State Bar of Texas and member of the Partnership and Real Estate Tax Committee of the Tax Section of the State Bar of Texas, also reviewed the Comments and provided substantive suggestions.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: October 5, 2020

I. INTRODUCTION

These Comments are provided in response to Treasury's and the IRS's request for comments regarding the Proposed Regulations. The Proposed Regulations relate to Section 1061 of the Code (the "Carried Interest Provision"), which provides that certain taxpayers that hold an "applicable partnership interest" must satisfy a three-year holding period in order to qualify for long-term capital gain treatment with respect to such applicable partnership interest.[1]

II. DEFINITION OF COMMODITIES

A. Background

By its terms, the Carried Interest Provision applies only to an applicable partnership interest ("API"). An API is defined as a partnership interest that "is transferred to (or is held by) [a] taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business."[2] An applicable trade or business (an "ATB") is defined as "any activity conducted on a regular, continuous, and substantial basis which . . . consists, in whole or in part, of," certain specified actions (the "Specified Actions") sufficient to constitute a trade or business under Section 162.[3] Such Specified Actions consist of both (i) raising or returning capital, and (ii) either (a) investing in or disposing of specified assets, or (b) developing specified assets.[4] Section 1061(c)(3) defines specified assets (the "Specified Assets") to include commodities within the meaning of Section 475(e)(2); the definition of Specified Assets in the Proposed Regulations tracks the language of Section 475(e)(2).[5] Commodity is defined broadly to include any actively traded personal property for which there is an established financial market, any derivative instrument in a commodity, any notional principal contract with respect to a commodity (e.g., a commodity swap), and a hedge with respect to a commodity.[6]

B. Discussion

It is unclear whether the definition in Section 475(e)(2) of "commodities" would include commodities that are produced in a trade or business for sale as inventory to customers. For example, oil, gas, and gold are "commodities," but a business exploring for and producing oil and gas or mining for gold does not actively trade such commodities on an established financial market. Instead, the business produces commodities as inventory for sale to customers in the ordinary course of its business. Further, mineral interests, royalty interests, overriding royalty interests and

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[1] I.R.C. § 1061(a). Unless otherwise noted, references in these Comments to a "Section" mean provisions of the Code.

[2] Prop. Reg. § 1.1061-1(a).

[3] Prop. Reg. §§ 1.1061-1(a), 1061-2(b)(1).

[4] Prop. Reg. § 1.1061-1(a); see I.R.C. § 1061(c)(2).

[5] Prop. Reg. § 1.1061-1(a).

[6] Prop. Reg. § 1.1061-1(a); I.R.C. §§ 475(e)(2)(A), 475(e)(2)(B), 475(e)(2)(C), 1092(d)(1); Treas. Reg. §§ 1.1092(d)-1(a), 1.446-3(c).

other similar non-cost bearing interests in oil and gas or other natural deposits are passive investments, and generally are not actively traded. We are not aware of any evidence that Congress intended to treat either commodities that are produced in a trade or business for sale as inventory to customers, or passive non-cost bearing mineral interests, as "commodities" for purposes of Section 1061(c)(3).[7]

C. Recommendations

We respectfully recommend that the Proposed Regulations be amended to incorporate a definition of "commodities" that explicitly excludes commodities produced in a trade or business for sale as inventory to customers in the ordinary course of such business. We further respectfully recommend that the Proposed Regulations clarify that Specified Assets include only commodities that are themselves *actually* actively traded on an established financial market, not merely commodities of the same *type* as commodities that are or can be actively traded on an established financial market.

III. AGGREGATION OF ACTIVITIES IN ATB TEST

A. Background

As explained above, an ATB must involve Specified Actions sufficient to constitute a trade or business under Section 162. The Proposed Regulations provide that an ATB includes "all Specified Actions taken by Related Persons" and "activities occurring in separate partnership tiers or entities as one ATB."[8]

B. Discussion

We respectfully note that there appears to be an ambiguity regarding what activities occurring in "separate partnership tiers or entities" will be combined as one ATB. Consider, for example, an owner taxpayer ("Owner Taxpayer") who provides substantial services to one partnership that holds no Specified Assets ("Fund 1"), in such Owner Taxpayer's capacity as an employee of a related person of Fund 1 ("Fund Sponsor"), and who receives a partnership interest in Fund 1 in connection with such services. Consider further that Fund Sponsor also engages in an ATB with respect to Specified Assets held by another partnership ("Fund 2"), in which Owner Taxpayer does not hold an interest. Owner Taxpayer is receiving the Fund 1 partnership interest only as an economic incentive to provide services to Fund 1, not in connection with Fund 2.

We respectfully suggest that the correct result in the example set forth above should be that the activities of Fund 1 are not aggregated with the activities of Fund 2 because there are no Specified Actions being conducted with respect to Fund 1, which holds no Specified Assets.[9] As a result, Fund 1 is not an ATB, and Owner Taxpayer's Fund 1 partnership interest is not an API

[7] Conf. Rep. ¶ 10,611.99. P.L. 115-97 (Dec. 22, 2017) excluding "real estate on which the holder operates an active farm" from the definition of "real estate held for rental or investment."

[8] Prop. Reg. §§ 1.1061-1(a), 1.1061-2(b)(1).

[9] Prop. Reg. §1.1061-2(b)(1).

because it was not received "in connection with the performance of substantial services" in an ATB. It is possible, however, that the requirement to combine "activities occurring in separate partnership tiers or entities as one ATB" as set forth in the Proposed Regulations could cause Fund 1 to be combined with the ATB of Fund 2. We respectfully suggest that such a result may be inconsistent with the policy goals of the statute as we understand them, and could result in an arbitrary application of Section 1061 based on the activities of Fund Sponsor.

C. Recommendation

We respectfully recommend that the Proposed Regulations be amended to include an example illustrating how the ATB and API rules work in this situation. The above example illustrates that the application of Section 1061 should be limited to an Owner Taxpayer solely with respect to partnership interests that serve as compensation for services relating to Specified Assets.

IV. TREATMENT OF SELF-CREATED GOODWILL

A. Background

The Proposed Regulations refer to the amount of long-term capital gain recharacterized as short-term capital gain under the Carried Interest Provision as the "Recharacterization Amount."[10] In computing the Recharacterization Amount, the Proposed Regulations exclude long-term capital gain and loss.[11]

B. Discussion

Section 1231 generally applies to gain or loss recognized on the sale or exchange of depreciable property used in a trade or business that is held for more than one year. Acquired goodwill held in connection with the conduct of a trade or business generally qualifies as an amortizable intangible (as defined in Section 197(c)), which is amortized ratably over a 15-year period. Under Section 197(f)(7), such acquired goodwill is treated as depreciable property, thereby causing any gain recognized on the sale of acquired goodwill to be treated as Section 1231 gain.

By contrast, self-created goodwill does not qualify as an amortizable intangible under Section 197; therefore, any gain recognized on the sale of self-created goodwill is not Section 1231 gain. Instead, self-created goodwill generally is treated as a capital asset giving rise to capital gain upon a sale or exchange of such goodwill. Accordingly, under the Proposed Regulations, gain on the sale of acquired goodwill would be excluded from the Recharacterization Amount, but gain on the sale of self-created goodwill would not be excluded. We are not aware of any evidence that Congress intended to subject self-created goodwill held in connection with a trade or business to the Carried Interest Provision.

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[10] *Id.* § 1.1061-4(a)(1).

[11] *Id.* §§ 1.1061-4(a)(2), 1.1061-4(b)(6)(i).

C. Recommendation

We respectfully recommend that the Proposed Regulations be clarified so that, in addition to the exclusion for Section 1231 gain, any gain recognized on the sale of goodwill held in connection with the conduct of a trade or business (whether or not determined under Section 1231) is also excluded from the Recharacterization Amount.

V. CAPITAL INTEREST EXCEPTION WITH RESPECT TO MANAGEMENT LOAN EXCLUSION

A. Background

For purposes of Proposed Regulation Sections 1.1061-1 through 1.1061-6, a capital account does not include the contribution of amounts directly or indirectly attributable to any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership (or any related person with respect to any such other partner or the partnership) (the "Management Loan Exclusion"). The Proposed Regulations, however, provide that "repayments on the loan are included in capital accounts as those amounts are paid by the partner, provided that the loan is not repaid with the proceeds of another loan described in [Section 1.1061-3(c)(3)(ii)(C) of the Proposed Regulations]."[12]

B. Discussion

It is not uncommon for a partnership service provider (a "Service Provider") to be issued an API in a partnership and, contemporaneously, to acquire a capital interest in the issuing partnership or a passthrough entity. In fact, the acquisition of a capital interest by a Service Provider is often encouraged in order to incentivize the Service Provider to achieve certain performance metrics. To fund its capital contribution, a Service Provider may obtain a loan from a third-party lender, another partner in the issuing partnership, or the issuing partnership itself.

While the Management Loan Exclusion would not apply to a capital interest funded through a third-party loan to the Service Partner, the Management Loan Exclusion would apply in the event a capital interest is funded through a loan from another partner (or any related person with respect to such other partner). The Management Loan Exclusion would apply even if the partner loan is made on exactly the same terms as a third-party loan, including adequate collateral or other recourse. We respectfully suggest that this result appears inconsistent with the exclusion of certain capital interests from APIs pursuant to Section 1061(c)(4)(B) (the "Capital Interest Exception"). As the Preamble to the Proposed Regulations explains, the policy behind the Capital Interest Exception is to except "long-term capital gains and losses that represent a return on an API Holder's invested capital in a Passthrough Entity from recharacterization under Section 1061."

We respectfully suggest that a Service Provider's invested capital in the issuing partnership or a passthrough entity should be treated consistently regardless of whether such capital interest is

[12] *Id.* § 1.1061-3(c)(3)(ii)(C).

funded by way of third-party financing or partner financing if the Service Provider has personal liability for the financing.

In the case of a capital interest funded through a loan from the issuing partnership, however, the current version of the Management Loan Exclusion appears consistent with the treatment of partnership loans under other areas of Subchapter K. For example, the contribution of a partner's own promissory note generally does not increase such partner's basis in its partnership interest under Section 722.[13] Similarly, pursuant to Treas. Reg. Section 1.704-1(b)(2)(iv)(d)(2), such partner's capital account will be increased with respect to such promissory note only when there is a taxable disposition of such note by the partnership or when the partner makes principal payments on such note, provided that such note is not readily tradable on an established securities market. No such limitations are applicable to capital interests funded through a loan from another partner (or a related person with respect to such partner) in the same partnership.

Other limitations, including, in certain cases, the at-risk limitation on losses under Section 465, may limit the deductibility of losses otherwise allowable under Section 1061. Under Section 465(b)(3), for example, the Service Provider would not be considered at-risk with respect to contributed capital that is financed through a loan from another partner, even if the loan were fully recourse to the Service Provider. A partner is considered at-risk, however, when an investment is funded by a third-party loan for which the partner has personal liability.[14]

C. Recommendation

We respectfully recommend that the Treasury reconsider the scope of the Management Loan Exclusion to the Capital Interest Exception and revise Proposed Regulation Section 1.1061-3(c)(3)(ii)(C) as follows:

> For purposes of Prop. Reg. Sections 1.1061-1 through 1.1061-6, a capital account does not include the contribution of amounts directly or indirectly attributable to any loan or other advance made or guaranteed, directly or indirectly, by *(1) the partnership (or any Related Person with respect to the partnership) or (2) any other partner (or any Related Person with respect to any such other partner, other than the partnership) if there is no personal liability to pay all or a substantial part of such indebtedness to such other partner (or any Related Person with respect to such other partner).*[15]

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[13] Rev. Rul. 80-235, 1980-2 C.B. 229; Oden v. Comm'r, T.C. Memo. 1981-184, *aff'd without published opinion*, 679 F.2d 885 (4th Cir. 1982).

[14] Treas. Reg. § 1.465-8(b)(1).

[15] (Emphasis added.) This language is identical to the language in Treas. Reg. § 1.83-3(b) ("The grant of an option to purchase certain property does not constitute a transfer of such property. … In addition, if the amount paid for the transfer of property is an indebtedness secured by the transferred property, on which there is *no personal liability to pay all or a substantial part of such indebtedness*, such transaction may be in substance the same as the grant of an option.").

VI. CAPITAL INTEREST ALLOCATIONS

A. Background

Proposed Regulation Section 1.1061-3(c) addresses certain capital interest gains and losses ("Capital Interest Gains and Losses"), which are intended to be an exception to API treatment. Capital Interest Gains and Losses are defined as capital interest allocations that meet the requirements of Proposed Regulation Section 1.1061-3(c)(4) ("Capital Interest Allocation"), passthrough interest capital allocations that meet the requirements of Proposed Regulation Section 1.1061-3(c)(5) ("Passthrough Interest Capital Allocations"); and capital interest disposition amounts that meet the requirements of Proposed Regulation Section 1.1061-3(c)(6).[16]

The Proposed Regulations limit the Capital Interest Exception by including only Capital Interest Allocations or Passthrough Interest Capital Allocations "that are made *in the same manner to all partners*."[17] The Proposed Regulations provide that allocations will be considered as having been made in the same manner to all partners if, under the partnership agreement, the allocations are based on the relative capital accounts of the partners (or the owners, in the case of a passthrough entity that is not a partnership) receiving the allocation, and the terms, priority, type, and level of risk, rate of return, and rights to cash or property distributions during the partnership's operations and on liquidation are the same.[18]

B. Discussion

i. Limited or No Unrelated Non-Service Partners

Under Proposed Regulation Section 1.1061-3(c)(4), the presence of a Capital Interest Allocation appears to be dependent upon the presence of unrelated non-Service Partners. This narrow definition excludes circumstances in which there are no or few unrelated non-Service Partners, but the Service Partners also have a capital interest. In a basic joint venture, two partners may put in capital and also provide services for the development of the underlying asset. If the underlying asset were a Specified Asset (e.g., real estate to be held for rental or investment), then each of these interests could be treated as an API under the Proposed Regulations, because no partner would be an unrelated non-Service Partner.

ii. Capital Interest Economically Separate from the Promote

An API holder managing a partnership investment vehicle (e.g., the general partner of a private equity fund) frequently invests capital alongside one or more unrelated non-Service Partners (as to any such party, a "Capital Investment"), but in many cases will not bear carried interest distributions (the "Promote") in the same manner as the unrelated non-Service Partners. Under Proposed Regulation Section 1.1061-3(c)(3)(i), an allocation to the API holder may qualify as a Capital Interest Allocation regardless of whether it is reduced by the cost of services provided

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[16] Prop. Reg. § 1.1061-3(c)(2).

[17] Prop. Reg. § 1.1061-3(c)(3)(i) (emphasis added).

[18] *Id.*

by the API holder or a related person.[19] It is unclear, however, how this rule would apply to the portion of an API holder's interest that does not bear the Promote.

Consider two examples in which the API holder contributes 5 percent of the capital and is entitled to a 20 percent Promote, and the unrelated non-Service Partners contribute the remaining 95 percent. In the first example, the API holder receives the first 5 percent of the distributions, and the remaining distributions are made 20 percent to the API holder for the Promote and 80 percent to the unrelated non-Service Partners. In the second example, the API holder receives the first 20 percent distributions for the Promote, and the remaining distributions are made 5 percent to the API holder and 95 percent to the unrelated non-Service Partners. In form, the API holder earns the Promote only in the second example because the API holder received a return of its capital in the first example before sharing in allocations in the same manner as the unrelated non-Service Partners. In substance, the distributions to the API holder are identical in both examples (i.e., 24 percent of the total), assuming a full return of capital to the partners, and the API holder ultimately earns the 20 percent Promote in both examples. For purposes of Section 1061, 4 percent of the allocations relating to distributions received by the API holder in each example should be characterized as a Capital Interest Allocation that is considered commensurate with the API holder's relative capital account balance.

The chart below provides a side-by-side comparison of the two examples discussed above.

		Distributions Ex 1	Distributions Ex 2	Allocations Ex 1 and 2
	Capital Percentages			
	API Holder Capital Int	5.00%	5.00%	
	UNSP Capital Int	95.00%	95.00%	
	Distributions			
	API Holder Capital Int	5.00%	4.00%	**4.00%**
5%/95% ratio				
	UNSP Capital Int	76.00%	76.00%	**76.00%**
80%/20% ratio				
	API Holder Promote	19.00%	20.00%	**20.00%**
	Total to API Holder = Same.	*24.00%*	*24.00%*	***24.00%***

C. Recommendations

First, we respectfully recommend that the definition of "Capital Interest Allocations" be expanded to include situations in which there are no or limited unrelated non-Service Partners, as long as the Service Partners also have a capital interest and allocations are made in the same manner to all partners. Second, we respectfully recommend that Proposed Regulation Section 1.1061-3(c)(3) be clarified to allow a Capital Interest Allocation to include the share of an

[19] *Id.*

API holder's Capital Investment that does not earn the Promote and thus remains economically separate from its interest that does earn the Promote.

VII. "RELATED PERSON" DEFINITION

A. Background

Under Section 1061(d)(1), the holder of an API recognizes short-term capital gain on the transfer of the API to a related person. Section 1061(d)(2) defines a "related person" in this context as a family member (within the meaning of attribution rules Section 318(a)(1)) or colleague that is a person who performed a service within the current calendar year or the preceding three calendar years in any ATB in which or for which the taxpayer performed a service. Proposed Regulation Section 1.1061-5(e)(1)(iii) expands the definition of a related person for purposes of Section 1061(d)(2) to include a passthrough entity to the extent that a member of the taxpayer's family or a colleague is an owner.

B. Discussion

We are not aware of any basis in the language or legislative history of Section 1061 for expanding the Section 1061(d)(2) definition of related persons. Because the Code is clear and unambiguous, we respectfully suggest that the Proposed Regulations should not modify the unambiguous intent of Congress as expressed in the statute.[20]

C. Recommendation

We respectfully recommend that the Proposed Regulations be amended to strike the expansion of "related persons" to include a passthrough entity to the extent that a member of the taxpayer's family or a colleague is an owner.

VIII. RECOGNITION ON TRANSFERS TO RELATED PARTIES

A. Background

As noted above, under Section 1061(d)(1), the holder of an API recognizes short-term capital gain on the transfer of the API to a related person. A related person is defined within Section 1061(d)(2) as a family member or colleague, and expanded in the current draft of the Proposed Regulations to include a passthrough entity with a family member or colleague owner.[21] Proposed Regulation Section 1.1061-5(b) provides that the term "transfer" for purposes of Section 1061(d) includes contributions, distributions, sales and exchanges, and gifts, regardless of whether such transfers would normally result in the recognition of gain. Proposed Regulation Section 1.1061-5(a) provides a formula based on a hypothetical partnership liquidation to calculate the Owner Taxpayer's short-term capital gain upon a transfer of an API to a related person.

[20] *Chevron USA Inc. v. Natural Resources Defense Council, Inc.*, 467 US 837, 842–43 (1984).

[21] I.R.C. § 1061(d)(2); Prop. Reg. § 1.1061-5(e)(1)(iii).

B. Discussion

i. Non-taxable Transactions

Gain or loss realized by the taxpayer on the sale or exchange of property must be recognized under Section 1001(c) unless a "nonrecognition" provision prescribes otherwise. The Code's numerous nonrecognition and exclusion provisions (e.g., Sections 1041, 2503, and 2523, and to the extent applicable, Sections 351, 721, and 731, among others) reflect the legislative judgment of Congress that the taxpayer's realized gain or loss should not be taxed when the transfer occurs.

The Proposed Regulations require gain recognition on certain related party API transfers, even if the transfer is not a transaction in which gain is otherwise recognized by the Code. We respectfully suggest that Section 1061(d)(1) should not be read to accelerate taxation for any transaction that would otherwise be a nonrecognition transaction under the Code absent explicit guidance from Congress. Further, we respectfully note that the approach in the Proposed Regulations appears to be unnecessary; the API in the hands of the transferee would still be subject to the Section 1061 regime under Section 1061(c)(1), because an API includes interests held by or transferred to the taxpayer in connection with the performance of a substantial service by the taxpayer *or a related person*.

ii. Formula for Calculating Short-Term Capital Gain on Related Person Transfer

Proposed Regulation Section 1.1061-5 provides a formula that applies a hypothetical liquidation to calculate the Owner Taxpayer's short-term capital gain upon a transfer of an API to a related person.[22] Because the Proposed Regulation Section 1.1061-5(c) calculation is not based on the Recharacterization Amount under a hypothetical liquidation, however, it includes amounts excluded from the Recharacterization Amount, such as capital interest gains and losses.[23]

iii. Transfers That Do Not Change Owner Taxpayer's Economic Position

Due to the expanded related party definition in Proposed Regulation Section 1.1061-5(e)(1) to include a passthrough entity if a family member or colleague is an owner, lower-tier transfers may involve a related party. We respectfully note that this could result in accelerated gain recognition in connection with "transfers" over which the Owner Taxpayer has no control and that do not result in any meaningful change in the Owner Taxpayer's economic position. While the Proposed Regulations provide an exclusion for Section 721(a) contributions, many non-recognition partnership transactions (including partnership divisions and mergers) involve transfers other than Section 721(a) contributions.

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[22] Prop. Reg. § 1.1061-5(a), (c).

[23] Such amounts are excluded from the Recharacterization Amount in Proposed Regulation Section 1.1061-3(c).

We are not aware of any evidence that Congress intended for a transaction like a partnership merger or division that does not result in a change in the Owner Taxpayer's economic position to be a transfer for purposes of Section 1061(d).

C. Recommendations

First, we respectfully recommend that Proposed Regulation Section 1.1061-5(b) be amended to include only taxable transfers and to exclude nonrecognition transactions, including: (i) transfers resulting from the death of an Owner Taxpayer; (ii) gifts to a non-grantor trust by an Owner Taxpayer; and (iii) transfers resulting from a change in tax status of a grantor trust.[24] Second, we respectfully recommend that the Proposed Regulations be amended to revise the formula for calculating an Owner Taxpayer's short-term capital gain upon a transfer of an API to a related person, so that such formula is based upon the Recharacterization Amount in a hypothetical partnership liquidation. Finally, we respectfully recommend that the Proposed Regulations be amended to add an exception from taxation under Proposed Regulation Section 1.1061-5 for transactions in which the Owner Taxpayer's deemed distributions with respect to the Owner Taxpayer's API on a hypothetical liquidation basis are the same immediately before and after the transaction (not including any deemed distributions due to changes in debt allocations).[25]

[24] We appreciate that the Proposed Regulations clarify that transfers to a grantor trust are disregarded for purposes of Section 1061. Prop. Reg. § 1.1061-2(a)(1)(v).

[25] We further respectfully note that Proposed Regulation Section 1.1061-5(c) already applies a hypothetical liquidation analysis.

TAX SECTION OF
THE STATE BAR OF TEXAS

2020 – 2021 CALENDAR

June 2020	
Monday 6/1/20	**SBOT Fiscal Year Begins**
Thurs - Fri 6/25-26/20	**SBOT Annual Meeting** Virtual via Zoom
Friday 6/26/20	**Award Presentation to Council and Chairs During Tax Section Annual Meeting Program and Tax Section Annual Meeting Program**
Tuesday 6/30/20	**Deadline to receive nominations for 2020-2021 Leadership SBOT class**
July 2020	
Friday 7/3/20	**July 4th (Holiday)**
Wednesday 7/15/20	**Tax Section Budget Deadline** Budget must be submitted to Executive Direction of State Bar of Texas
Thurs - Sat 7/16-18/20	**Texas Bar College - Summer School 2020** Texas Bar CLE Webcast
Wed – Tues 7/29 – 8/4/20	**ABA Annual Meeting** Convening for Justice – Virtual Meeting
August 2020	
Wednesday 8/5/20	**Officers' Retreat** Via Zoom 8:30 a.m.
Wednesday 8/5/20	**First Wednesday Tax Update** 12:00 p.m.
Monday 8/10/20	**SBOT Chair and Treasurer Training** Via Zoom 10:30 a.m. – 2:30 p.m.
Friday 8/21/20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Thurs – Fri 8/27-28/20	**Tax Law 2020: A Practical Guide to Tax Law in the Real World Online CLE** Texas Bar CLE Webcast

Sept 2020	
Wednesday 9/2/20	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 9/2/20	**Officers' Call** 1:00 p.m.
Monday 9/7/20	**Labor Day (Holiday)**
Thursday 9/10/20	**SBOT Executive Committee Meeting**
Friday 9/11/20	**Submission Deadline – Texas Tax Lawyer (Fall Edition)** Submit to TTL Editor: Aaron Borden email: aaron.borden@us.gt.com
Friday 9/11/20	**Meeting of Council, Committee Chairs, and Committee Vice Chairs** Via Zoom 9:00 a.m. – 11:30 a.m.
Thursday 9/17/20	**Posting deadline for agenda of September SBOT Board of Directors Meeting**
Friday 9/18/20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Friday 09/18/20	**Outreach to Law Schools (not yet scheduled)**
Fri-Sun 9/18–20/20	**Rosh Hashanah (Religious Holiday)**
Monday 9/21/20	**Tax Court Pro Bono Calendar Call-Houston (Regular Case)**
Mon-Fri 9/21-25/20	**ABA Business Law Section Annual Meeting** Virtual
Thursday 9/24/19	**Deadline for Chair to Appoint Nominating Committee** (90 days after Annual Meeting per Bylaws Section 4.1)
Thurs-Fri 9/24-25/20	**SBOT Board of Directors Meeting**
Sun-Mon 9/27-28/20	**Yom Kippur (Religious Holiday)**
Tues. 9/29/20	**Zooming into Tax Court CLE**
Tues. 9/29/20	**Law School Outreach - SMU**

9/29-10/2/20	**ABA Tax Section 2020 Fall Meeting** online
Oct 2020	
Wednesday 10/7/20	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 10/7/20	**Officers' Call** 1:00 p.m.
Monday 10/12/20	**Columbus Day (Holiday)**
Tues-Fri 10/13-16/20	**Tax Court Pro Bono Calendar Call –Houston (Small Case)**
Friday 10/16/20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Monday 10/19/20	**Tax Court Pro Bono Calendar Call-Dallas (Small Case)**
Mon - Thurs 10/19-22/20	**Council on State Taxation (COST) 51st Annual Meeting** Webinar
Friday 10/23/20	**Council of Chairs Meeting** 10:30 a.m. – 2:30 p.m.
Fri - Sat 10/23-24/20	**National Association of State Bar Tax Sections ("NASBTS") Annual Meeting** (members may attend at their own expense) TBD
Monday 10/26/20	**Tax Court Pro Bono Calendar Call-Las Vegas (Regular Case)**
Saturday 10/31/20	**Insurance Renewal is Due** **Note Premium Paid by Big Bar!**
Nov 2020	
Monday 11/2/20	**Annual Meeting Deadline** Submit date and time preference for CLE programs, section meetings, council meetings, socials, and special events.
Wednesday 11/4/20	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 11/4/20	**Officer's Call** 1:00 p.m.
Wed - Thurs 11/4-5/20	**Austin Chapter CPA Annual Tax Conference** Norris Conference Center, Austin, Texas

Thursday 11/5/20	**State Bar of Texas Pro Bono Workgroup Meeting** Via Zoom 10:00 a.m. - 1:00 p.m.
Friday 11/6/20	**Meeting of Council** Via Zoom 9:00 a.m. – 11:00 a.m.
Monday 11/9/20	**Tax Court Pro Bono Calendar Call-Houston (Regular Case)**
Monday 11/9/20	**Tax Court Pro Bono Calendar Call-Dallas (Regular Case)**
Wednesday 11/11/20	**Veterans Day (Holiday)**
TBD	**Comptroller Annual Meeting Briefing**
Thurs-Fri 11/19-20/20	**International Tax Law Symposium** Virtual
Friday 11/20/20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Thursday 11/26/20	**Thanksgiving Day (Holiday)**
Dec. 2020	
Wednesday 12/2/20	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 12/2/20	**Officers' Call** 1:00 p.m.
Wed - Thurs 12/2-3/20	**UT Law 67th Annual Taxation Conference** Virtual
Tues - Wed 12/8-9/20	**Texas Taxpayers and Research Association (TTARA) Annual Meeting** Virtual - TBD
Sun - Mon 12/10-18/20	**Hanukkah (Other Holiday)**
Thurs-Sat 12/10-12/20	**ABA Section of Taxation National Institute: Criminal Tax Fraud/Tax Controversy** Wynn Resort, Las Vegas, NV
Friday 12/18/20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.

Friday 12/25/20	**Christmas (Holiday)**
Jan. 2021	
Friday 1/1/21	**New Year's Day (Holiday)**
Monday 1/4/21	**Annual Meeting Deadline** Submit programming for the registration brochure, CLE topics, speakers, and speaker contact information and firm.
Wednesday 1/6/21	**Officers' Call** 1:00 p.m.
Tuesday 1/12/21	**SBOT Executive Committee Meeting**
Thursday 1/14/21	**Posting deadline for agenda of January SBOT Board of Directors Meeting** •
Friday 1/15/21	**Nomination Period Opens for 2021 Outstanding Texas Tax Lawyer Award** • Nominations due April 1, 2021 • Nomination forms to be posted on website • Submit nomination forms to Tax Section Secretary: Henry Talavera
Friday 1/15/21	**Meeting of Council, Committee Chairs, and Committee Vice Chairs** Virtual
Monday 1/18/21	**Martin Luther King Jr. Day (Holiday)**
Thurs-Fri 1/21-22/21	**SBOT Board of Directors Meeting** Holiday Inn, Tyler (tentative)
Friday 1/22/21	**Submission Deadline – Texas Tax Lawyer (Winter Edition)** Submit to TTL Editor: Aaron Borden email: aaron.borden@us.gt.com
Monday 1/25/21	**Tax Court Pro Bono Calendar Call-San Antonio (Regular Case)**
Thurs - Sat 1/28-30/21	**ABA Section of Taxation Midyear Meeting** JW Marriott LA Live, Los Angeles, CA
Feb. 2021	
Monday 2/1/21	**Register and make guest room reservations for Annual Meeting (www.texasbar.com/annualmeeting)**
Wednesday 2/3/21	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 2/3/21	**Officers' Call** 1:00 p.m.

Friday 2/4-5/20	**SBOT Tax Section Tax Law in a Day CLE** Virtual (Half Day each day)
Monday 2/8/21	**Tax Court Pro Bono Calendar Call-Lubbock (Hybrid Case)**
Monday 2/15/21	**President's Day (Holiday)**
Wed – Mon 2/17-22/21	**ABA Midyear Meeting** Hyatt Regency Chicago, Chicago, IL
Friday 2/19/21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Monday 2/22/21	**Annual Meeting Deadline** Order special awards, council and chair plaques, food and beverage, and AV.
Friday 02/26/21	**Council of Chairs Meeting and Section Representative Election** Texas Law Center (tentative) 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
March 2021	
Monday 3/1/21	**Nomination Deadline** Tax Section Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members SBOT and TYLA President-Elect and Director positions
Monday 3/1/21	**Tax Court Pro Bono Calendar Call-San Antonio (Small Case)**
Wednesday 3/3/21	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 3/3/21	**Officers' Call** 1:00 p.m.
Thursday 3/11/21	**Nominating Committee Conference Call** Via Zoom 9:00 a.m.
Friday 3/19/21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Monday 3/22/21	**Tax Court Pro Bono Calendar Call-Dallas (Regular Case)**

TBD	**2021 State Bar of Texas Property Tax Committee Meeting & Legal Seminar** Thompson Conference Center - UT Campus 2405 Robert Dedman Dr. Austin, Texas 78712
Monday 3/29/21	**Tax Court Pro Bono Calendar Call-Houston (Regular Case)**
Monday 3/29/21	**Tax Court Pro Bono Calendar Call-El Paso (Hybrid Case)**
Sat-Sat 3/27-4/3/21	**Passover (Religious Holiday)**
Tuesday 3/30/21	**Nominating Committee Report Due to Council** (10 days prior to meeting preceding Annual Meeting per Bylaws Section 4.1)
April 2021	
Thursday 4/1/21	**Nominations for Outstanding Texas Tax Lawyer Due to Henry Talavera** Email**:** HTalavera@Polsinelli.com
Thursday 4/1/21	**Deadline for section year-end reports for publication in the Texas Bar Journal**
Fri, Sun 4/2, 4/21	**Good Friday, Easter (Religious Holiday)**
Monday 4/5/21	**Annual Meeting Deadline** Course materials for app, CLE articles, PowerPoints, speaker bios and photos
Monday 4/5/21	**Law Student Scholarship Application Deadline**
Wednesday 4/7/21	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 4/7/21	**Officers' Call** 1:00 p.m.
Friday 4/9/21	**Meeting of Council** Via Zoom 9:00 a.m. – 11:00 a.m. **Note: Council Vote and Selection of Recipient of 2021 Outstanding Texas Tax Lawyer Award**
Friday 4/9/21	**Submission Deadline – Texas Tax Lawyer (Spring Edition)** Submit to TTL Editor: Aaron Borden email: aaron.borden@us.gt.com
Monday 4/12/21	**Annual Meeting Deadline** Submit any final programming changes for onsite event guide, CLE topic titles, speakers, speaker contact information and firm

Thurs – Fri 4/15-16/21	**SBOT Board of Directors Meeting** Hilton, Waco (tentative) Announcement of Chair of the Board Election results
Friday 4/16/21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
May 2021	
Saturday 5/1/21	**National Law Day**
Wednesday 5/5/21	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 5/5/21	**Officers' Call** 1:00 p.m.
Thurs – Sat 5/13-15/21	**ABA Section of Taxation May Meeting** Marriott Marquis, Washington, DC
Sun – Mon 5/16-17/21	**Shavuot (Religious Holiday)**
Monday 5/17/21	**Annual Meeting - Last Day of Early Bird Registration**
Friday 5/21/21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Friday 5/21/21	**Deadline to make guest room reservations for Annual Meeting at discounted rate (www.texasbar.com/annualmeeting)**
Monday 5/30/21	**Deadline to Deliver to Members or Post on Tax Section Website Notice of Annual Meeting** (20 days prior to Annual Meeting per Bylaws Section 7.1) **Deadline to Deliver to Members or Post on Tax Section Website Nominating Committee Report** (20 days prior to Annual Meeting per Bylaws Section 4.1)
Monday 05/31/21	**Memorial Day (Holiday)**
June 2021	
6/1/21	**SBOT Fiscal Year begins**
Wednesday 6/2/21	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 6/2/21	**Officers' Call** 1:00 p.m.

Wed – Fri 6/2-4/21	**Annual Texas Federal Tax Institute** La Cantera Resort, San Antonio, Texas
Thursday 6/17/21	**2021 Tax Section Annual Meeting Speaker's Dinner and Presentation of Outstanding Texas Tax Lawyer** TBD
Thurs – Fri 6/17-18/21	**SBOT Annual Meeting** Omni, Fort Worth (tentative)
Friday 6/18/21	**2021 Tax Section Annual Meeting Program and Award Presentation to Council and Chairs During Tax Section Annual Meeting Program** TBD
Friday 6/18/21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.

Other Events Not Yet Scheduled	
Spring 2021	**Tax Court Pro Bono Calendar Call**
TBD	**SBOT Tax Section Deep Dive Tax Workshop CLE**
TBD	**Law School Outreach**
Future Annual Meeting Dates and Locations	
Thurs-Fri 6/9-10/22	**State Bar of Texas Annual Meeting** Marriott Marquis, Houston
Thurs-Fri 6/22-23/23	**State Bar of Texas Annual Meeting** JW Marriott, Austin
Thurs-Fri 6/20-21/24	**State Bar of Texas Annual Meeting** Hilton Anatole, Dallas

Bylaws Section 7.4: Notice of regular meetings shall be delivered to the Council members by electronic mail, U.S. mail, overnight delivery service, or posting on the Section's website (or combination thereof) at least ten days prior to the date designated for such regular meeting.

TAX SECTION

STATE BAR OF TEXAS

LEADERSHIP ROSTER

2020-2021

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TAX SECTION
THE STATE BAR OF TEXAS
COMMITTEE CHAIRS AND VICE CHAIRS
2020-2021

	COMMITTEE	CHAIR	VICE CHAIR
1.	**Annual Meeting**	**Laurel Stephenson** Davis Stephenson, PLLC 100 Crescent Ct., Suite. 440 Dallas, Texas 75201 *(214) 396-8802* laurel@davisstephenson.com **John Strohmeyer** Strohmeyer Law PLLC 2925 Richmond Avenue 12th Floor Houston, Texas 77098 *(713) 714-1249* john@strohmeyerlaw.com	**Mr. William David Elliott** Elliott, Thomason & Gibson, LLP 2626 Cole Ave, Suite 600 Dallas, Texas 75204-1053 *(214) 922-9393* bill@etglawfirm.com
2.	**Continuing Legal Education**	**Abbey B. Garber** Thompson & Knight 1722 Routh Street, Suite 1500 Dallas, Texas 75201 *(214) 969-1640* Abbey.Garber@tklaw.com **Michael Threet** Haynes and Boone, LLP 2323 Victory Avenue, Suite 700 Dallas, Texas 75219 *(214) 651-5091* michael.threet@haynesboone.com **Amanda Traphagan** Seay & Traphagan, PLLC 807 Brazos St., Suite 304 Austin, Texas 78701 *(512) 582-0120* atraphagan@seaytaxlaw.com	

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12.	**Newsletter**	**Aaron Borden** Grant Thornton 1717 Main Street, Suite 1800 Dallas, Texas 75201 *(214) 561-2604* Aaron.Borden@us.gt.com	

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	COMMITTEE	CHAIR	VICE CHAIR
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