Texas Tax Lawyer

A Tax Journal

Winter 2020 • Vol. 47 • No. 2

TAX SECTION
STATE BAR OF TEXAS

www.texastaxsection.org

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Dear Fellow Tax Section Members:

Welcome to 2020. The future is NOW and the Texas Tax Section is here to celebrate it!

Thanks to Our Editor

A big THANK YOU to **Michelle Spiegel**, our long-time editor of the *Texas Tax Lawyer*, who has generously offered continued commitment and hard work to deliver an outstanding *Texas Tax Lawyer* publication three times every year. Michelle is moving on to an exciting new venture, joining her husband in his growing litigation practice at Humphrey Law PLLC, where her practice will expand into a variety of litigation projects – not just tax law. She has been grooming **Aaron Borden** to take over as editor for the next season and has graciously agreed to see us through the rest of this State Bar year, while training her successor.

Tax Section Annual Meeting

Register for the Tax Section Annual Meeting today and book your hotel room now! Internal Revenue Service Commissioner **Charles P. Rettig** has accepted the Tax Section's invitation to speak at the State Bar Annual Meeting in Dallas on **Friday, June 26, 2020, at the Hilton Anatole Hotel**. The annual meeting also features the interview of nationally-acclaimed Texas Tax Legend **Emily A. Parker** of Thompson & Knight LLP in Dallas by our favorite interviewer **William D. Elliott**, and a panel collaboration with the Immigration and Naturalization Law Section, on Pre-Immigration Tax Planning. People moving to the United States have much to learn about how the American tax system works. The panel will discuss how potential consequences of acquiring a visa or Green Card vary from client to client. This presentation will review the income tax and estate and gift tax consequences of immigration to the United States. **John Strohmeyer**, of the Tax Section, will collaborate with **Matthew Myers** of the Immigration and Naturalization Section for this informative and timely presentation.

Meeting registration is active and the hotel room block is open. Details are available at: https://www.texasbar.com/AM/Template.cfm?Section=Annual_Meeting_Home&Template=/CM/HTMLDisplay.cfm&ContentID=40322

We are also planning an off-site reception in **Dallas** on **June 25, 2020 at 6:00 p.m.** for speakers, past chairs of the Texas Tax Section, officers, council members, committee chairs, and committee vice-chairs who will be attending the annual meeting. Invitations and details will be coming out soon. The reception will be available to the first 50 invitees who RSVP so please watch your inboxes for the invitation!

All Tax Section members are invited to join us for the Annual Member meeting and awards ceremony **Friday, June 26, 2020, at 8:00 a.m.**, as part of the State Bar meeting. Tax Section members and attendees of the annual meeting are invited to attend our CLE program as well. You must be registered for the annual meeting to get CLE credit. This year's council retreat will not be held in conjunction with the annual meeting, reimbursement is only available for speakers.

Register Here:

https://www.texasbar.com/AM/Template.cfm?Section=Annual_Meeting_Home&Template=/CM/HTMLDisplay.cfm&ContentID=40322

Pro Bono Committee

The Pro Bono Committee has been hopping with numerous training events, calendar call appearances, and representation at settlement days under the guidance of **Rachael Rubenstein** and **Bob Probasco**. The committee has set up a SignUpGenius page for volunteers.

The VITA Adopt-a-Base program has been going strong with volunteers devoted to training at Fort Bliss, Fort Hood, Fort Sam Houston, Lackland AFB, and Goodfellow AFB. Tax Section volunteers also assisted taxpayers at Tax Court calendar calls and settlement days, as well as at various events in Houston, Dallas, and San Antonio. **Bob Probasco** attended a State Bar pro bono workgroup meeting in Austin on November 6, 2019, at which the group provided very positive feedback on an overview of the Tax Section pro bono programs.

Property Tax Committee Meeting & Legal Seminar

The Texas State Bar Property Tax Committee Meeting & Legal Seminar will be held on **Friday, March 27, 2020,** at the **Thompson Conference Center at the University of Texas at Austin**. The Conference Center is located at the Northeast edge of the UT Campus. This program will include a case law update, an overview of delinquent tax matters, chief appraisers' panel, ethics, and sessions on exhaustion of administrative remedies and presenting expert appraisers. The agenda and registration are available on the Tax Section website. Many thanks to **Daniel Smith** and the planning committee for their hard word to make this program an annual success.

International Tax Symposium

The 22nd Annual International Tax Symposium took place on November 21–22, 2019 in Houston. There were 44 attendees. The Tax Section received positive comments from attendees on the quality of speakers and topics. Thank you, **John Strohmeyer** and team!

Tax Law in a Day

The Tax Law in a Day program was held Friday, February 7, 2020 in Houston at the Westin Galleria. There were 42 attendees. They gave positive feedback on the topics and speakers covered. The audience included not only tax lawyers but also general litigators and others. Many thanks to **Renesha Fountain**, **Harriet Wessel**, **Anne Schwartz**, and everyone else who helped plan an amazing program.

First Wednesday Tax Update

The Tax Section continues its wildly popular free webcast series, "First Wednesday Tax Update." The webcasts are offered the first Wednesday of each month, focus on recent developments in federal income taxation, and are presented by **Professor Bruce McGovern**, Professor of Law and Director, Tax Clinic, South Texas College of Law Houston (and may

occasionally include other guest speakers). We hope you will make plans to watch the webcast each month, but if you miss it, check the Tax Section's 24/7 online library after a few weeks.

Congratulations Leadership Academy Graduates!

The graduation session of the 2019–2020 State Bar Tax Section Leadership Academy was held in San Antonio on January 23–24, 2020. There were 18 graduates of the program. This year's Leadership Academy graduates are: **Ira Aghai, Aaron Borden, Shannon Brandt, Carolyn Chachere Starr, Brian Clark, Stuart H. Clements, Blair Marie Green, Christopher James, Mark A. McMillan, Julio Mendoza-Quiroz, Adrian Ochoa, Ryan D. Phelps, John B. Reyna, Jameson Eliseo Sauseda, Leo Unzeitig, Joshua S. Veith, Hersh Mohun Verma,** and **Sarah G. Woodberry**.

Over the course of the program, the 18 graduates were addressed by two United States Tax Court Judges (**The Honorable Elizabeth Copeland**, **The Honorable Juan F. Vasquez**); the Comptroller's Office (**Nancy Prosser**); University of Houston Law School (**Professor Bret Wells**); University of Texas Law School (**Amber Hackett Crosby**); and professionals from Baker Botts (**Bobby Phillpott**); Chamberlain Hrdlicka (**Charles J. "Chad" Muller**); Elliott, Thomason, & Gibson (**William D. Elliott**, **Kevin Thomason**); Ernst & Young (**Greg Matlock**); Hayse LLC (**Roger Hayse**); Jackson Walker (**William H. "Willie" Hornberger**); Meadows, Collier, Reed, Cousins, Crouch & Ungerman, L.L.P. (**Matthew Beard**); Northern Trust (**Nolan Moulle**); Norton Rose Fulbright (**Jay Chadha, Adam Harden, Steve Kuntz, Rob Morris, Todd Schroeder**); Rapid 7 (**Jeffrey Garza**); Thompson & Knight (**Abbey Garber, Emily Parker**); Vinson & Elkins (**Neil Clausen, Jason McIntosh**); and in-house tax professionals (**Jose Nogales** and **Michael Villegas**). The topics were wide-ranging and covered subjects from United States Tax Reform to Understanding Online Threats and How to Deal with Them to Taking Charge of Your Future and Reasons to Get Involved in the Tax Profession. The

graduation dinner was held at Morton's Steakhouse in San Antonio. **Emily Parker** addressed the graduates with an inspiring presentation.

A special thank you to **Rob Morris** for the outstanding job he did planning and organizing this year-long program!

Welcome to Our New Ex Officio Council Member

During our January 10, 2020, meeting of officers, council, committee chairs, and committee vice-chairs, we amended the Tax Section bylaws to allow the chair to appoint an ex-officio member to council who serves in government in the property tax area. The bylaws changes were ratified by the State Bar as part of the consent agenda later that month. I have appointed **Dustin L. "Dusty" Banks**, in-house counsel for the Travis Central Appraisal District, to fill the new role. We already are blessed with the participation of ex-officio members **Audrey G. Morris**, of the Internal Revenue Service Office of Chief Counsel, and **James D. Arbogast,** Chief Counsel for Tax Hearings and Litigation at the Texas Comptroller of Public Accounts, which allows for collaboration with those agencies; and we wanted to expand that scope to encompass our colleagues from the property tax area as well.

Committee on Governmental Submissions

Sam Megally has continued leading very effective, efficient monthly calls of the Committee on Governmental Submissions (COGS). The Tax Section has been busy issuing comments to the Internal Revenue Service and preparing to testify on proposed regulations in Washington D.C.

COGS submitted a comment letter on February 17, 2020 regarding the Proposed Regulations on Certain Employee Remuneration in Excess of $1,000,000 under Internal Revenue Code Section 162(m). This comment letter was a joint project between COGS and the Employee Benefits Committee. The principal drafters were **Henry Talavera**, Treasurer of the Tax Section, and **Jessica Morrison,** Vice-Chair of the Employee Benefits Committee. **James Griffin**, Chair of the Employee Benefits Committee and **Mark A. Bodron** reviewed the comments and made substantive suggestions. **Sam Megally** also reviewed the comments and made suggestions on behalf of COGS. **Rafael Ramos Aguirre**, who works with Henry Talavera, but is not a member of the Texas Tax Section, also assisted with the comments.

Henry Talavera is scheduled to travel to Washington D.C. to represent the Texas Tax Section in a public hearing on the proposed regulations on March 9, 2020.

The monthly COGS conference calls are scheduled for the third Friday of each month at 11:00 a.m. The calls are very brief and efficient. It is very important for at least one representative of each substantive committee to dial in to the monthly COGS call, even if there have been no specific projects identified by the committee. It is critical for us to be able to collaborate with other committees, to ensure various stakeholders' interests are addressed. Even if you are not representing a committee, if you are interested in participating in COGS projects, please join the calls and volunteer to help. The details are included on the Tax Seciton calendar and in the monthly updates that each committee distributes to its members.

Law School Outreach

The Tax Section's Law School Outreach initiative is well underway. The Tax Section has provided panel presentations to law students at Texas Tech University School of Law, Texas A&M University School of Law, UNT Dallas College of Law, SMU Dedman School of Law, University of Houston Law Center, Baylor Law School, Thurgood Marshall School of Law at Texas Southern, and St. Mary's University School of Law. There is a remaining planned program at The University of Texas School of Law on March 3, 2020. Many thanks to **Audrey Morris** and **Abbey Garber** for their continued hard work and dedication to this program.

Share the News About Law School Scholarship Applications

The application period for law school scholarships opened in January 2020. Applications are available on our website. The purpose of this scholarship is to facilitate and encourage students to enter the practice of tax law in Texas, and to become active members of the Texas Tax Section, by assisting these students with their financial needs. Applications must be postmarked or received by April 4, 2020 and can be emailed to **Professor Alyson Outenreath** at Alyson.Outenreath@ttu.edu. The scholarships will be awarded at the State Bar Annual Meeting in Dallas this June.

Nominate Your Colleague for the Outstanding Texas Tax Lawyer Award

The nominations period for the annual Texas Tax Lawyer Award opened on January 1, 2020. Help us continue this long-standing tradition by nominating a candidate. Nomination forms are available on the Tax Section website. Nominations should be submitted to **Dan Baucum**, Tax Section Secretary, at dbaucum@baucumlaw.com no later than **April 1, 2020**. The award is scheduled be presented at the annual meeting reception on Thursday, June 25 in Dallas in conjunction with the 2020 Annual Meeting of the Tax Section.

Texas Tax Section Presence at ABA Tax Section Midyear Meeting in Boca Raton, FL

The Texas Tax Section's strong presence was visible at the American Bar Association Section of Taxation's Midyear Meeting held in Boca Raton, Florida, January 30, 2020 through February 1, 2020. On Thursday afternoon, **Harriet Wessel** presented on a Tax Bridge to Practice Panel: Getting to the Truth: Fundamentals of Discovery & Public Records for SALT Lawyers sponsored by the Court Practice and Procedure Committee.

On Friday, **Abbey Garber** presented on Practical Privilege Issues for the Administrative Practice Committee. **Jeffrey Chadwick** presented on Optimizing Lifetime Gifts: Advising Clients in Uncertain Times. **Professor William Byrnes,** of the Texas A&M University School of Law, in Fort Worth participated in a panel entitled A "Quick Dip" in the Water – A Summary of Recent Transfer Pricing Issues. **Jaquelyn Meng Abbott** presented on Employee Benefits Welfare Plans and EEOC, FMLA and Leaves Issues Update with the Subcommittee on Welfare Plan and EEOC, FMLA and Leaves Issues, including a discussion of *Texas vs. United States.* **Scott C. Thompson** presented on the Employee Benefits New Employee Benefits Attorneys Forum, which he chairs. He also served on a panel covering Employee Benefits ESOP Updates with **Allison Wilkerson**. **Meredith VanderWilt** presented an update on Employee Benefits Defined Benefit Plans. **Sarah Fry** of The North American Coal Corp. in Plano, served on a panel for the Employee Benefits Corporate Counsel Forum. **Nolan A. Moulle III** of Northern Trust in Houston presented with a panel of lawyers from the Estate & Gift Taxes and Fiduciary Income Tax

Young Lawyers Subcommittee and presented A Refresher on the Throwback Tax. **Jeffrey M. Glassman** moderated a panel reporting on Tax Court developments, significant IRS guidance and litigation, an update on Tax Division priorities, and a discussion of significant pending litigation. The panel included **Joshua Wu**, Deputy Assistant Attorney General (Policy and Planning), Department of Justice, Tax Division, Washington, DC. **Abdon Rangel** presented a panel on Mitigation Banking. **Adam C. Harden** participated on a panel covering Legislative, Treasury and Internal Revenue Service Updates, including the "new" Office of Tax Exempt Bonds; the status of the Final Reissuance Regulations; the proposed regulations addressing reference rates other than Interbank Offered Rates; *Indian River County v. U.S. Department of Transportation* (Dec. 20, 2019), the Internal Revenue Service Business Plan items for 2019-2020; and the Internal Revenue Service Audit Plan (Fiscal Year 2020 Compliance Program). **Brad Roe** of Grant Thornton in Houston presented on Planning Considerations and Issues for Trusts as Owners of S Corporations and Other Closely Held Business.

On Saturday morning, **Professor Bryan T. Camp** of the Texas Tech University School of Law in Lubbock participated in a panel on Innocent Spouse Litigation Under the Taxpayer First Act. **John R. Strohmeyer** presented on Trust & Estate Distributions to Foreign Beneficiaries where he discussed the income tax consequences and reporting requirements when domestic trusts and estates make distributions to foreign beneficiaries. **Christopher Cunningham** served on a panel entitled “Watts This? Does No Good Deed Go Unpunished?”, which covered a case involving the "Edwin Watts" chain of Florida golf stores and issues raised by that case, including when an ordinary abandonment loss can be claimed on a partnership interest, when a taxpayer can affirmatively apply the doctrine of substance over form, how foregone gain is to be treated for income tax purposes, and when reliance on an accountant’s determination as to ordinary abandonment loss can be relied on to defeat penalties. **Michael A. Villa Jr., Mary Wood, Joseph M. Erwin**, **Professor Bruce A. McGovern**, and **Lewis A. Booth**, Office of Chief Counsel, Internal Revenue Service, in Houston, TX, served on panels covering important updates in the area of civil and criminal tax penalties. **Jason B. Freeman** followed by participating in a panel addressing what to do when a client with a Cryptocurrency Issue calls.

Professor Bruce A. McGovern wrapped up Saturday afternoon with his presentation on Current Developments in Individual Corporate, Partnership, and Estate & Gift Taxation. There were also many other participants, panelists and committee leaders from Texas involved in this very informative meeting. Texas has always been and continues to be a strong participant in the ABA Tax Section.

Deadline for the Spring Edition of the Texas Tax Lawyer

The deadline for submitting articles for the Spring edition of the Texas Tax Lawyer is **April 10, 2020**. Any members interested in submitting articles should contact **Aaron Borden** at Aaron.Borden@us.gt.com or **Michelle Spiegel** at michelle@humphreylawpllc.com.

Sponsorships

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

Join a Committee

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

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

Contact Information

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:

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(512) 542-9300
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Tax Section Administrator
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Houston, Texas

TAX SECTION
STATE BAR OF TEXAS

2020
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 Dan G. Baucum, Tax Section Secretary by email to dbaucum@baucumlaw.com no later than April 1, 2020.

[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 2020 OUTSTANDING TEXAS TAX LAWYER AWARD

Nominee Name: _____

Nominee Mailing Address, Phone, and Email:

_____

_____

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:

_____

_____

TAX SECTION
State Bar of Texas

Law Students Pursuing Tax Law Scholarship Application

The Tax Section of the State Bar of Texas annually awards up to three $2,000 scholarships to students demonstrating academic excellence and commitment to the study and practice of tax law. Any student who is enrolled in an ABA accredited law school at the time the application is submitted, and who intends to practice tax law in Texas, is eligible to apply. Thus, persons who have been accepted to law school, but have not yet started classes at the time the application is filed, are ineligible to apply. However, persons who have recently graduated at the time the scholarship is awarded are eligible to apply.

The purpose of this scholarship is to facilitate and encourage students to enter the practice of tax law in Texas, and to become active members of the State Bar Tax Section, by assisting these students with their financial needs. Selection criteria of the scholarships include: merit, scholarship performance, financial need, and demonstrated experience and interest in the field of tax law. Consideration is also given to extracurricular activities both inside and outside law school, including but not limited to legal externships or internships with state or federal taxing authorities such as the Internal Revenue Service, Office of the Texas Comptroller of Public Accounts, or Texas-based legal aid societies and clinics.

A completed application must be returned by email to Alyson Outenreath at Alyson.Outenreath@ttu.edu.

All information, including supporting documentation such as letters of recommendation and transcripts, must be included in a single submission. Transcripts do not need to be in original or certified form. Please scan all of the documents and attach the scan to an email as a single document in PDF form. Incomplete applications will not be accepted.

Applications must be time stamped by no later than **April 4, 2020**. The scholarships will be awarded at the State Bar Annual Meeting in June 2020 in Dallas, Texas. Winners need not be present to accept the award.

Please print or type.

I. GENERAL INFORMATION

NAME: _____

E-MAIL ADDRESS: _____

MAILING ADDRESS: _____

_____

CELL PHONE: _____ ALTERNATE PHONE: _____

II. EDUCATIONAL INFORMATION

LAW SCHOOL NAME: _____

GPA (cumulative): _____ EXPECTED GRADUATION DATE: _____

CLASS RANK: _____

UNDERGRADUATE COLLEGE NAME: _____

DEGREE: ____ MAJOR: _____ GPA: _____ GRADUATION DATE: _____

GRADUATE DEGREES including LL.M. Programs (College, Degree, Date):

_____

_____

Please attach a copy of all college, graduate school (if any), and most recent law school transcripts. If your law school transcript does not include your grades for the most recent closed grading term, please separately provide information on all grades you have received to date and supplement your application with remaining grades as soon as possible after you receive them.

LAW SCHOOL ACTIVITIES AND/OR HONORS:

COMMUNITY ACTIVITIES:

Responses regarding law school activities and/or honors and community activities may be made in typewritten form of no more than one page in length.

III. RECOMMENDATIONS AND ESSAY

Please attach (1) one or more letters of recommendation and (2) a typewritten essay of no more than two pages in length (double spaced) addressing the following:

- Why you plan to pursue a career in tax law in Texas;
- What are your long-term career goals;
- List of the tax courses you have completed and grade received, and tax courses you are currently taking; and
- Any qualifications that you believe are relevant for your consideration for this scholarship. For example, students may describe relevant research, published articles, clubs, competitions, clinics, community service, job or internship or externship experience.

- (Optional) Any issues of financial need that you would like the Committee to consider.

AFFIRMATION OF APPLICANT: By signing below, I certify that all the information provided as part of this application is true and correct. I understand that the Tax Section's Scholarship Selection Committee reserves the right to investigate all information stated in this application.

Applicant's Signature: _____ Date: _____

CHANGES TO PARTNERSHIP RECOURSE LIABILITIES IN FINAL REGULATIONS: UNDERSTANDING THE CLIFF EFFECT

by Lee Meyercord and Jessica Kirk*

On October 4, 2019, the IRS released final regulations under section 752.[1] Our Article titled "IRS Final Regulations Eliminate Bottom-Dollar Guarantees" in the Fall 2019 edition of the Texas Tax Lawyer summarized bottom-dollar guarantees, their use in tax-planning, and the temporary and final regulations under section 752 that ended the viability of bottom-dollar guarantees.[2]

The regulations under section 752 also address when partnership liabilities are considered recourse liabilities to partners, including a partner who is an entity disregarded as separate from its owner for federal income tax purposes. This Article summarizes the prior regulations and final regulations, including the so-called "cliff effect" created by the final regulations when there is no commercially reasonable expectation that a partner can pay the full amount of partnership liabilities.

Use of Debt Allocations in Tax Planning and Prior Regulations

A partner's basis determines the amount of distributions that a partner can receive tax-free and the amount of partnership losses that flow-through to the partner.[3] A partner's basis in her partnership interest includes her share of partnership liabilities.[4] For partnership basis allocation purposes, partnership liabilities are classified as recourse or nonrecourse.[5] A partnership liability is recourse and allocated to a specific partner if that partner bears the economic risk of loss for the liability.[6] By contrast, if no partner bears the economic risk of loss, a partnership liability is nonrecourse and allocated among the partners in accordance with the three-tier allocation rules in Treasury Regulations Section 1.752-3.[7]

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* Lee Meyercord is a partner in the Dallas office of the law firm Thompson & Knight L.L.P. and can be contacted at lee.meyercord@tklaw.com. Jessica Kirk is an associate in the Dallas office of the law firm Thompson & Knight L.L.P. and can be contacted at jessica.kirk@tklaw.com.

[1] T.D. 9877, 84 Fed. Reg. 54,014 (Oct. 9, 2019).

[2] Lee Meyercord & Jessica Kirk, *IRS Final Regulations Eliminate Bottom-Dollar Guarantees*, Texas Tax Lawyer, Fall 2019.

[3] *See* I.R.C. § 704(d)(1); Treas. Reg. § 1.731-1(a)(1)(i).

[4] I.R.C. §§ 722; 752(a).

[5] Treas. Reg. §§ 1.752-1(a)(1)-(2).

[6] Treas. Reg. §§ 1.752-1(a)(1); 1.752-2(a).

[7] Treas. Reg. §§ 1.752-1(a)(2); 1.752-3.

A partner bears the economic risk of loss to the extent that the partner would be obligated to pay the liability in a constructive liquidation.[8] The determination of whether a partner bears the economic risk of loss is based on the facts and circumstances and takes into account statutory and contractual obligations such as guarantees, indemnifications, and reimbursement agreements.[9] There is a presumption that partners and related persons with payment obligations actually perform those obligations, irrespective of their net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.[10] This is referred to as the satisfaction presumption.

Under the prior regulations, the satisfaction presumption was subject to an exception for a disregarded entity that did not have sufficient net value to pay the debt.[11] For example, A owns 100% of LLC, a disregarded entity for federal income tax purposes. A contributes $200,000 to LLC. A has no liability for LLC's debts or obligation to make a contribution to LLC.[12] LLC contributes $100,000 to a partnership in exchange for a partnership interest. The partnership incurs a $300,000 liability guaranteed by LLC. Under the prior regulations, the debt would be bifurcated and treated as recourse to A to the extent of LLC's net value of $100,000.[13] The balance would be a nonrecourse liability allocated among the partners under Treasury Regulations Section 1.752-3.

Proposed Regulations

In 2014, the IRS issued proposed regulations expanding the net value requirement to all partners and related persons other than individuals or estates.[14] The preamble to the 2014 proposed regulations requested comments concerning whether the net value rule should also apply to individuals and estates.[15] After considering the comments to the proposed regulations, the "IRS and Treasury Department agreed that expanding the application of the net value rules under 1.752-2(k) may lead to more litigation and unduly burden taxpayers."[16] In addition, the IRS and Treasury

[8] Treas. Reg. §§ 1.752-2(b)(1); 1.752-2(b)(5) ("A partner's or related person's obligation to make a payment with respect to a partnership liability is reduced to the extent that the partner or related person is entitled to reimbursement from another partner or a person who is a related person to another partner."); 1.752-2(j)(3) ("An obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation.").

[9] Treas. Reg. § 1.752-2(b)(3).

[10] Treas. Reg. § 1.752-2(b)(6).

[11] Treas. Reg. § 1.752-2(k) [prior to amendment by T.D. 9877, 84 Fed. Reg. 54,014 (Oct. 9, 2019)].

[12] *See also* Treas. Reg. § 1.752-2(k)(6), Ex. (2) [prior to amendment by T.D. 9877, 84 Fed. Reg. 54,014 (Oct. 9, 2019)].

[13] Treas. Reg. § 1.752-2(k) [prior to amendment by T.D. 9877, 84 Fed. Reg. 54,014 (Oct. 9, 2019)].

[14] REG-119305-11, 79 Fed. Reg. 4826 (Jan. 30, 2014).

[15] *Id.* at 4831.

[16] REG-12285-15, 81 Fed. Reg. 69,301, 69,305.

Department recognized that the net value requirement may not accurately take into account future earnings of a business entity, which would factor into lending decisions.[17]

On October 5, 2016, the IRS and Treasury issued proposed regulations that removed the net value requirement, and instead added a presumption to the section 752 anti-abuse rule.[18] Under this presumption, evidence of a plan to circumvent or avoid the obligation under the section 752 anti-abuse rule would have been deemed to exist if the facts and circumstances indicated that there was not a reasonable expectation that the debt would be repaid.[19] If such evidence was deemed to exist, the obligation could not be recognized for purposes of determining whether a partner had the economic risk of loss and the liability would be nonrecourse.[20]

Final Regulations

On October 4, 2019, the IRS released final regulations which were published in the Federal Register on October 9, 2019.[21] The final regulations take a different approach than the proposed regulations in an effort to more "accurately reflect economics."[22] Thus, the final regulations are focused on "whether a debtor will have the ability to make payments when due, not necessarily . . . whether the debtor has sufficient assets to satisfy an obligation currently."[23]

No Commercially Reasonable Expectation of Payment. The final regulations continue to apply the satisfaction presumption described above, but provide an exception if the facts and circumstances show that "there is not a commercially reasonable expectation that the payment obligor will have the ability to make the required payments under the terms of the obligation if the obligation becomes due and payable."[24] Factors that a third party creditor would take into account when determining whether to grant a loan are facts and circumstances to be considered when determining whether there was a commercially reasonable expectation of payment.[25] In addition, the partner's ability to pay may be based on documents, such as balance sheets, income statements, cash flow statements, credit reports, and projected future financial results.[26] The IRS has described the test as an "earnings potential" test rather than a net worth test.[27]

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[17] *Id*.

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] T.D. 9877, 84 Fed. Reg. 54,014.

[22] *Id.* at 54,020.

[23] *Id.*

[24] Treas. Reg. § 1.752-2(k).

[25] *Id.*

[26] T.D. 9877, 84 Fed. Reg. 54,020.

[27] Eric Yauch & Lee A. Sheppard, *IRS Clarifies Aspects of Partnership Debt Regs*, Tax Notes, Feb. 3, 2020.

The final regulations give two examples illustrating this rule. The first example involves a disregarded entity (LLC) with no assets other than the partnership interest.[28] The regulations conclude that LLC's payment obligation is disregarded because LLC "has no assets with which to pay if the payment obligation becomes due and payable" and therefore "there is no commercially reasonable expectation that LLC will be able to satisfy its payment obligation."[29] The debt is nonrecourse and allocated among the partners according to the rules in Treasury Regulations Section 1.752-3.

In the second example, the facts are the same except that LLC holds real property with a net worth of $275,000 and the real property earns $20,000 of net rental income per year.[30] The regulations conclude that in this case "there is a commercially reasonable expectation that LLC will be able to satisfy its payment obligation" and therefore the debt is characterized as recourse and allocable entirely to the owner of the disregarded entity.[31]

The Cliff Effect. Neither of the examples in the final regulations explain whether the commercially reasonable expectation analysis would allow partnership debt to be bifurcated and treated as partially nonrecourse to a partner as was permitted for disregarded entities under the old regulations.[32] On January 28, 2020, the IRS informally confirmed practitioner's suspicions that the final regulations do not allow for bifurcation.[33] Instead, they take an all-or-nothing approach.[34] The all-or-nothing approach in the regulations is called a "cliff effect" because the full amount of partnership debt is treated as nonrecourse if there is no reasonable expectation that the guaranteeing partner can pay the full amount of partnership liabilities. For example, in the second example above, if there was a "commercially reasonable expectation" that LLC will be able to satisfy 50% of the debt but not all of the debt, the entire liability is treated as nonrecourse as opposed to 50% nonrecourse and 50% recourse to the owner of LLC.[35]

Effective Dates and Transitional Rule. The final regulations discussed in this Article apply to liabilities and payment obligations occurring on or after October 9, 2019, unless such liabilities

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[28] Treas. Reg. § 1.752-2(k)(2)(i), Ex. (1).

[29] *Id*.

[30] Treas. Reg. § 1.752-2(k)(2)(ii), Ex. (2).

[31] *Id*.

[32] Treas. Reg. §§ 1.752-2(k)(2) (i)-(ii), Ex. (1)-(2).

[33] Eric Yauch & Lee A. Sheppard, *IRS Clarifies Aspects of Partnership Debt Regs*, Tax Notes, Feb. 3, 2020**.** (explaining that Holly Porter, IRS Associate Chief Counsel (Passthrough and Special Industries) confirmed on January 28, 2020 at a New York State Bar Association conference that the application of the section 752 regulations "is a cliff test.").

[34] *Id.*

[35] At least one commentator has suggested that the cliff effect could be the subject of a *Chevron* challenge because there was no notice of the cliff effect in the prior regulations. Eric Yauch, *ABA Section of Taxation Meeting: IRS Hears Grievances on Cliff Effect of Debt Rules*, Tax Notes, Feb. 10, 2020.

or payment obligations were pursuant to a written binding contract effective before that date.[36] However, taxpayers may choose to apply the final regulations discussed in this Article to their liabilities at the beginning of the first taxable year of the partnership ending on or after October 5, 2016.[37]

Conclusion

While the commercially reasonable expectation rule may be more lenient than the prior net value rule, it is less certain in its application. Partners will need to make the commercial reasonable expectation determination on an annual basis.[38] A reduction in a partner's earning potential could cause a partnership liability to be treated as nonrecourse. The reduction of a partner's share of partnership liabilities in excess of basis triggers gain.[39] Thus, this onerous annual determination could create traps for the unwary if there is a change in a partner's earning potential.

[36] Treas. Reg. § 1.752-2(l)(1).

[37] *Id.*

[38] Eric Yauch, *ABA Section of Taxation Meeting: IRS Hears Grievances on Cliff Effect of Debt Rules*, Tax Notes, Feb. 10, 2020 (Caroline Hay, branch 1 attorney, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries) confirmed that the commercially reasonably expectation determination is done annually).

[39] I.R.C. §§ 752(b); 731(a)(1).

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
First Wednesday Tax Update
December 4, 2019

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I. ACCOUNTING

A. Accounting Methods

B. Inventories

C. Installment Method

D. Year of Inclusion or Deduction

1. Accrual-method taxpayers may have to recognize income sooner as a result of legislative changes. The 2017 Tax Cuts and Jobs Act, § 13221, amended Code § 451 to make two changes that affect the recognition of income and the treatment of advance payments by accrual method taxpayers. Both changes apply to taxable years beginning after 2017. Any change in method of accounting required by these amendments for taxable years beginning after 2017 is treated as initiated by the taxpayer and made with the consent of the IRS.

All events test linked to revenue recognition on certain financial statements. The legislation amended Code § 451 by redesignating § 451(b) through (i) as § 451(d) through (k) and adding a new § 451(b). New § 451(b) provides that, for accrual-method taxpayers, "the all events test with respect to any item of gross income (or portion thereof) shall not be treated as met any later than when such item (or portion thereof) is taken into account as revenue in" either (1) an applicable financial statement, or (2) another financial statement specified by the IRS. Thus, taxpayers subject to this rule must include an item in income for tax purposes upon the earlier of satisfaction of the all events test or recognition of the revenue in an applicable financial statement (or other specified financial statement). According to the Conference Report that accompanied the legislation, this means, for example, that any unbilled receivables for partially performed services must be recognized to the extent the amounts are taken into income for financial statement purposes. Income from mortgage servicing contracts is not subject to the new rule. The new rule also does not apply to a taxpayer that does not have either an applicable financial statement or another specified financial statement. An "*applicable financial statement*" is defined as (1) a financial statement that is certified as being prepared in accordance with generally accepted accounting principles that is (a) a 10-K or annual statement to shareholders required to be filed with the Securities and Exchange Commission, (b) an audited financial statement used for credit purposes, reporting to shareholders, partners, other proprietors, or beneficiaries, or for any other substantial nontax purpose, or (c) filed with any other federal agency for purposes other than federal tax purposes; (2) certain financial statements made on the basis of international financial reporting standards and filed with certain agencies of a foreign government; or (3) a financial statement filed with any other regulatory or governmental body specified by IRS.

Advance payments for goods or services. The legislation amended Code § 451 by redesignating § 451(b) through (i) as § 451(d) through (k) and adding a new § 451(c). This provision essentially codifies the deferral method of accounting for advance payments reflected in Rev. Proc. 2004-34, 2004-22 I.R.B. 991. New § 451(c) provides that an accrual-method taxpayer who receives an advance payment can either (1) include the payment in gross income in the year of receipt, or (2) elect to defer the category of advance payments to which such advance payment belongs. If a taxpayer makes the deferral election, then the taxpayer must include in gross income any portion of the advance payment required to be included by the applicable financial statement rule described above, and include the balance of the payment in gross income in the taxable year following the year of receipt. An advance payment is any payment: (1) the full inclusion of which in gross income for the taxable year of receipt is a permissible method of accounting (determined without regard to this new rule), (2) any portion of which is included in revenue by the taxpayer for a subsequent taxable year in an applicable financial statement (as previously defined) or other financial statement specified by the IRS, and (3) which is for goods, services, or such other items as the IRS may identify. The term "advance payment" does *not* include several categories of items, including rent, insurance premiums, and payments with respect to financial instruments.

a. Guidance on accounting method changes relating to new § 451(b). Rev. Proc. 2018-60, 2018-51 I.R.B. 1045 (11/29/18). Rev. Proc. 2018-60 modifies Rev. Proc. 2018-31, 2018-22 I.R.B. 637, to provide procedures under § 446 and Reg. § 1.446-1(e) for obtaining automatic consent with respect to accounting method changes that comply with § 451(b), as amended by 2017

Tax Cuts and Jobs Act, § 13221. In addition, Rev. Proc. 2018-60 provides that for the first taxable year beginning after December 31, 2017, certain taxpayers are permitted to make a method change to comply with § 451(b) without filing a Form 3115, Application for Change in Accounting Method.

b. Proposed regulations issued on requirement of § 451(b)(1) that an accrual method taxpayer with an applicable financial statement treat the all events test as satisifed no later than the year in which it recognizes the revenue in an applicable financial statement. REG-104870-18, Taxable Year of Income Inclusion Under an Accrual Method of Accounting, 84 F.R. 47191 (9/9/19). The Treasury Department and the IRS have issued proposed regulations regarding the requirement of § 451(b)(1), as amended by the 2017 Tax Cuts and Jobs Act, that accrual method taxpayers with an applicable financial statement must treat the all events test with respect to an item of gross income (or portion thereof) as met no later than when the item (or portion thereof) is taken into account as revenue in either an applicable financial statement (AFS) or another financial statement specified by the IRS (AFS income inclusion rule). New Prop. Reg. § 1.451-3 clarifies how the AFS income inclusion rule applies to accrual method taxpayers with an AFS. Under Prop. Reg. § 1.451-3(d)(1), the AFS income inclusion rule applies only to taxpayers that have one or more AFS's covering the entire taxable year. In addition, the proposed regulations provide that the AFS income inclusion rule applies on a year-by-year basis and, therefore, an accrual method taxpayer with an AFS in one taxable year that does not have an AFS in another taxable year must apply the AFS income inclusion rule in the taxable year that it has an AFS, and does not apply the rule in the taxable year in which it does not have an AFS. The proposed regulations clarify that the AFS income inclusion rule does not change the applicability of any exclusion provision, or the treatment of non-recognition transactions, in the Code, regulations, or other published guidance. Generally, the proposed regulations (1) clarify how the AFS inclusion rule applies to multi-year contracts; (2) describe and clarify the definition of an AFS for a group of entities; (3) define the meaning of the term "revenue" in an AFS; (4) define a transaction price and clarify how that price is to be allocated to separate performance obligations in a contract with multiple obligations; and (5) describe and clarify rules for transactions involving certain debt instruments. The regulations are proposed to apply generally to taxable years beginning on or after the date final regulations are published in the Federal Register. Because the tax treatment of certain fees (such as certain credit card fees), referred to as "specified fees," is unclear, there is a one-year delayed effective date for Prop. Reg. § 1.451-3(i)(2), which applies to specified fees. Until final regulations are published, taxpayers can rely on the proposed regulations (other than the proposed regulations relating to specified fees) for taxable years beginning after December 31, 2017, provided that they: (1) apply all the applicable rules contained in the proposed regulations (other than those applicable to specified fees), and (2) consistently apply the proposed regulations to all items of income during the taxable year (other than specified fees). Taxpayers can similarly rely, subject to the same conditions, on the proposed regulations with respect to specified credit card fees for taxable years beginning after December 31, 2018.

c. Proposed regulations issued on advance payments for goods or services received by accrual method taxpayers with or without an applicable financial statement. REG-104554-18, Advance Payments for Goods, Services, and Other Items, 84 F.R. 47175 (9/9/19). The Treasury Department and the IRS have issued proposed regulations regarding accrual method taxpayers with or without an applicable financial statement (AFS) receiving advance payments for goods or services. The proposed regulations generally provide that an accrual method taxpayer with an AFS includes an advance payment in gross income in the taxable year of receipt unless the taxpayer uses the deferral method in § 451(c)(1)(B) and Prop. Reg. § 1.451-8(c) (AFS deferral method). A taxpayer can use the AFS deferral method only if the taxpayer has an AFS, as defined in § 451(b)(1)(A)(i) or (ii). The term AFS is further defined in Prop. Reg. § 1.451-3(c)(1), issued on the same day as these proposed regiulations. Under the AFS deferral method, a taxpayer with an AFS that receives an advance payment must include: (i) the advance payment in income in the taxable year of receipt, to the extent that it is included in revenue in its AFS, and (ii) the remaining amount of the advance payment in income in the next taxable year. The AFS deferral method closely follows the deferral method of Rev. Proc. 2004-34 (as modified by Rev. Proc. 2011-14, 2011-4 I.R.B. 330, and as modified and clarified by Revenue Procedure 2011-18, 2011-5 I.R.B. 443, and Rev. Proc. 2013-29, 2013-33 I.R.B. 141). A similar deferral method is provided in § 1.451–8(d) for accrual method

taxpayers thay do not have an AFS (non-AFS deferral method). Under the non-AFS deferral method, a taxpayer that receives an advanced payment must include (1) the advance payment in income in the taxable year of receipt to the extent that it is earned, and (2) the remaining amount of the advance payment in income in the next taxable year. In Prop. Reg. § 1.451–8(b)(1)(i), the proposed regulations clarify that the definition of advance payment under the AFS and non-AFS deferral methods is consistent with the definition of advance payment in Revenue Procedure 2004–34, which § 451(c) was meant to codify.The regulations are proposed to apply to taxable years beginning on or after the date the final regulations are published in the Federal Register. Until then, taxpayers can rely on the proposed regulations for taxable years beginning after December 31, 2017, provided that the taxpayer: (1) applies all the applicable rules contained in the proposed regulations, and (2) consistently applies the proposed regulations to all advance payments.

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

C. Reasonable Compensation

D. Miscellaneous Deductions

E. Depreciation & Amortization

1. Certain depreciation and amortization provisions of the 2017 Tax Cuts and Jobs Act:

a. Increased limits and expansion of eligible property under § 179.

Increased § 179 Limits. The 2017 Tax Cuts and Jobs Act, § 13101, increased the maximum amount a taxpayer can deduct under § 179 to $1 million (increased from $520,000). This limit is reduced dollar-for-dollar to the extent the taxpayer puts an amount of § 179 property in service that exceeds a specified threshold. The legislation increased this threshold to $2.5 million (increased from $2,070,000). These changes apply to property placed in service in taxable years beginning after 2017. The legislation did not change the limit on a taxpayer's § 179 deduction for a sport utility vehicle, which remains at $25,000. The basic limit of $1 million, the phase-out threshold of $2.5 million, and the sport utility vehicle limitation of $25,000 all will be adjusted for inflation for taxable years beginning after 2018.

Revised and expanded definition of qualified real property. The 2017 Tax Cuts and Jobs Act, § 13101, also simplified and expanded the definition of "qualified real property," the cost of which can be deducted under § 179 (subject to the applicable limits just discussed). Prior to amendment by the 2017 Tax Cuts and Jobs Act, § 179(f) defined qualified real property as including "qualified leasehold improvement property," "qualified restaurant property," and "qualified retail improvement property." The legislation revised the definition of qualified real property by replacing these three specific categories with a single category, "qualified improvement property" as defined in § 168(e)(6). Section 168(e)(6) defines qualified improvement property (subject to certain exceptions) as "any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service." In addition, the legislation expands the category of qualified real property by defining it to include the following improvements to nonresidential real property placed in service after the date the property was first placed in service: (1) roofs, (2) heating, ventilation, and air-conditioning property, (3) fire protection and alarm systems, and (4) security systems. These changes apply to property placed in service in taxable years beginning after 2017.

Section 179 property expanded to include certain personal property used to furnish lodging. The 2017 Tax Cuts and Jobs Act, § 13101, also amended Code § 179(d)(1). The effect of this amendment is to include within the definition of § 179 property certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging (such as beds or other furniture, refrigerators, ranges, and other equipment).

Guidance on the procedure for electing to treat qualified real property as § 179 property. In Rev. Proc. 2019-8, 2019-3 I.R.B. 347 (12/21/18), the IRS provided the procedure by which taxpayers can elect to deduct the cost of qualified real property under § 179(a). According to the notice, for qualified real property placed in service in taxable years beginning after 2017, taxpayers make the election "by filing an original or amended Federal tax return for that taxable year in accordance with procedures similar to those in § 1.179-5(c)(2) and section 3.02 of Rev. Proc. 2017–33." Taxpayers that have filed an original return can elect to increase the portion of the cost of qualified real property deducted under § 179(a) by filing an amended return and will not be treated as having revoked a prior election under § 179 for that year.

b. Goodbye, basis; hello 100 percent § 168(k) bonus first-year depreciation!

100 percent bonus depreciation for certain property. The 2017 Tax Cuts and Jobs Act, § 13201, amended Code § 168(k)(1) and 168(k)(6) to permit taxpayers to deduct 100 percent of the cost of qualified property for the year in which the property is placed in service. This change applies to property *acquired and placed in service* after September 27, 2017, and before 2023. The percentage of the property's adjusted basis that can be deducted is reduced from 100 percent to 80 percent in 2023, 60 percent in 2024, 40 percent in 2025, and 20 percent in 2026. (These periods are extended by one year for certain aircraft and certain property with longer production periods). Property *acquired on or before September 27, 2017* and placed in service after that date is eligible for bonus depreciation of 50 percent if placed in service before 2018, 40 percent if placed in service in 2018, 30 percent if placed in service in 2019, and is ineligible for bonus depreciation if placed in service after 2019.

Used property eligible for bonus depreciation. The legislation also amended Code § 168(k)(2)(A) and (E) to make used property eligible for bonus depreciation under § 168(k). Prior to this change, property was eligible for bonus depreciation only if the original use of the property commenced with the taxpayer. This rule applies to property *acquired and placed in service* after September 27, 2017. Note, however, that used property is eligible for bonus depreciation only if it is acquired "by purchase" as defined in § 179(d)(2). This means that used property is *not* eligible for bonus depreciation if the property (1) is acquired from certain related parties (within the meaning of §§ 267 or 707(b)), (2) is acquired by one component member of a controlled group from another component member of the same controlled group, (3) is property the basis of which is determined by reference to the basis of the same property in the hands of the person from whom it was acquired (such as a gift), or (4) is determined under § 1014 (relating to property acquired from a decedent). In addition, property acquired in a like-kind exchange is not eligible for bonus depreciation.

Qualified property. The definition of "qualified property" eligible for bonus depreciation continues to include certain trees, vines, and plants that bear fruits or nuts (deductible at a 100 percent level for items planted or grafted after September 27, 2017, and before 2023, and at reduced percentages for items planted or grafted after 2022 and before 2027). The definition also includes a qualified film or television production. Excluded from the definition is any property used in a trade or business that has had floor plan financing indebtedness (unless the business is exempted from the § 163(j) interest limitation because its average annual gross receipts over a three-year period do not exceed $25 million).

Section 280F $8,000 increase in first-year depreciation. For passenger automobiles that qualify, § 168(k)(2)(F) increases by $8,000 in the first year the § 280F limitation on the amount of depreciation deductions allowed. The legislation continues this $8,000 increase for passenger automobiles *acquired and placed in service* after 2017 and before 2023. For passenger automobiles acquired *on or before* September 27, 2017, and placed in service after that date, the previously scheduled phase-down of the $8,000 increase applies as follows: $6,400 if placed in service in 2018, $4,800 if placed in service in 2019, and $0 after 2019.

c. Changes to the 280F depreciation limits on passenger automobiles and removal of computer and peripheral equipment from the definition of listed property. The 2017 Tax Cuts and Jobs Act, § 13202, amended Code § 280F(a)(1)(A) to increase the maximum amount of allowable depreciation for passenger automobiles and for which bonus depreciation under § 168(k) is not claimed. The maximum amount of allowable depreciation is $10,000 for the year in which the

vehicle is placed in service, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years in the recovery period. The legislation also amended § 280F(d)(4) to remove computer or peripheral equipment from the definition of listed property. Both changes apply to property placed in service after 2017 in taxable years ending after 2017.

d. Changes to the depreciation of certain property used in a farming business.

Modifications to the depreciation of farm machinery and equipment. The 2017 Tax Cuts and Jobs Act, § 13203, made two changes with respect to the depreciation of any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) that is used in a farming business. (For this purpose, the term "farming business" is defined in Code § 263A(e)(4).) The legislation amended Code § 168(b)(2) and (e)(3)(B) to repeal the required use of the 150 percent declining balance method and to reduce the recovery period from 7 years to 5 years. Accordingly, such machinery and equipment should be depreciable over 5 years using the double-declining balance method and the half-year convention. This change applies to property placed in service after 2017 in taxable years ending after 2017.

Mandatory use of ADS for farming businesses that elect out of the new interest limitation. The 2017 Tax Cuts and Jobs Act, § 13205, amended Code § 168 to add new § 168(g)(1)(G), which requires a farming business that elects out of the newly-enacted interest limitation of § 163(j) to use the alternative depreciation system for any property with a recovery period of 10 years or more. This change applies to taxable years beginning after 2017. Note: aside from longer recovery periods, the requirement to use the alternative depreciation system for property with a recovery period of 10 years or more would seem to have the effect of making such property ineligible for bonus depreciation under § 168(k) even if it normally would be eligible for bonus depreciation.

- For guidance on the application of the alternative depreciation system in this situation, see Rev. Proc. 2019-8, 2019-3 I.R.B. 347 (12/21/18).

e. Revised definitions and minor adjustments to recovery periods for real property. With respect to real property, the 2017 Tax Cuts and Jobs Act, § 13204, amended Code § 168 to simplify certain definitions and make minor adjustments for purposes of the alternative depreciation system.

Three categories consolidated into one. The legislation replaced the categories of "qualified leasehold improvement property," "qualified restaurant property," and "qualified retail improvement property" with a single category, "qualified improvement property." Code § 168(e)(6) defines qualified improvement property (subject to certain exceptions) as "any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service." Qualified improvement property is depreciable over 15 years using the straight-line method and is subject to the half-year convention. This change applies to property placed in service after 2017. **Note:** the Conference Agreement indicates that the normal recovery period for qualified improvement property is 15 years, but § 168 as amended does not reflect this change. This should be addressed in technical corrections.

Residential rental property has a 30-year ADS recovery period. The legislation reduced the recovery period for residential rental property for purposes of the alternative depreciation system from 40 years to 30 years. The general recovery period for such property remains at 27.5 years. This change applies to property placed in service after 2017. An optional depreciation table for residential rental property with a 30-year ADS recovery period appears in Rev. Proc. 2019-8, 2019-3 I.R.B. 347 (12/21/18).

Mandatory use of ADS for real property trades or businesses electing out of the new interest limitation. The legislation amended Code § 168 to add new § 168(g)(1)(F) and (g)(8), which require a real property trade or business that elects out of the newly-enacted interest limitation of § 163(j) to use the alternative depreciation system for nonresidential real property, residential rental property, and qualified improvement property. This change applies to taxable years beginning after 2017. Note: aside from longer recovery periods, the requirement to use the alternative depreciation system for qualified

improvement property would seem to have the effect of making qualified improvement property ineligible for bonus depreciation under § 168(k).

- For guidance on the application of the alternative depreciation system in this situation, see Rev. Proc. 2019-8, 2019-3 I.R.B. 347 (12/21/18).

f. The IRS has issued final regulations that provide guidance on § 168(k) first-year depreciation. T.D. 9874, Additional First Year Depreciation Deduction, 84 F.R. 50108 (9/24/19). The Treasury Department and the IRS have finalized, with some changes, proposed regulations issued under § 168(k) in 2018. See REG-104397-18, Additional First Year Depreciation Deduction, 83 F.R. 39292 (8/8/18). These regulations provide guidance regarding the additional first-year depreciation deduction (so-called "bonus depreciation") under § 168(k) as amended by the 2017 Tax Cuts and Jobs Act. They affect taxpayers who deduct depreciation for qualified property acquired and placed in service after September 27, 2017. Generally, the regulations provide detailed guidance on the requirements that must be met, including specific requirements that apply to used property, for depreciable property to qualify for the additional first-year depreciation deduction provided by § 168(k). The preamble to the final regulations notes that some comments submitted on the proposed regulations had requested that the final regulations provide that "qualified improvement property" (discussed above) placed in service after 2017 is eligible for additional first-year depreciation under § 168(k). The Treasury Department and the IRS declined to adopt this suggested change because the relevant statutory provisions do not permit it. Although the Conference Agreement that accompanied the 2017 Tax Cuts and Jobs Act states that qualified improvement property is depreciable over 15 years, § 168 as amended by the 2017 Tax Cuts and Jobs Act does not reflect this change. Accordingly, the recovery period for qualified improvement property is 39 years. Because property that qualifies for the additional first-year depreciation deduction generally must have a revocery period of 20 years or less, qualified improvement property placed in servce after 2017 is not eligible for bonus depreciation. The final regulations are effective on September 24, 2019, but taxpayers can choose to apply them in their entirely to qualified property acquired and placed in service (or planted or grafted) after September 27, 2017, during taxable years ending on or after September 28, 2017. For qualified property acquired and placed in service (or planted or grafted) after September 27, 2017, during taxable years ending after that date and before September 24, 2019, taxpayers can rely on the proposed regulations.

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. "Bitcoin is not a currency." "No surprise" says Professor Omri Marian.[1] Notice 2014-21, 2014-16 I.R.B. 938 (3/25/14). This Notice "describes how existing general tax principles apply to transactions using virtual currency." The notice has two main components: (1) a substantive part (i.e., how Bitcoin transactions should be taxed), and (2) an information reporting part (i.e., how income on Bitcoin transactions should be reported and how tax can be collected).

[1] This discussion of Notice 2014-21 is adapted, with permission, from a TaxProf Blog op-ed by Profesor Omri Y. Marian, who at the time was a member of the faculty of the University of Florida Levin College of Law (and now is a member of the faculty at the University of California Irvine School of Law), on March 26, 2014, available at http://taxprof.typepad.com/taxprof_blog/2014/03/marian-bitcoin.html. We thank Prof. Marian for granting us permission to include his work in this outline. See also Omri Y. Marian, *Are Cryptocurrencies 'Super' Tax Havens?*, 112 MICHIGAN LAW REVIEW FIRST IMPRESSIONS 38 (2013).

Substance. The substantive part of the Notice provides very few surprises. The most important conclusions are as follows.

(1) Bitcoin is *not* a currency for tax purposes; it is property. As such, gain and losses on the disposition of Bitcoins can never be "exchange gain or loss." This may come as a disappointment to taxpayers who lost money in Bitcoin investments and may have hoped to have the losses classified as exchange-losses, and, as such, as ordinary losses. On the other hand, taxpayers who have disposed of appreciated investment positions in Bitcoins may enjoy capital gains treatment. Taxpayers who hold Bitcoin as inventory will be subject to ordinary gains and losses upon disposition.

(2) The receipt of Bitcoin in exchange for goods and services is taxable at the time of receipt. The amount realized is the U.S. dollar value of the Bitcoins received. The disposition of Bitcoin in exchange for goods and services is a realization and recognition event to the extent the value of Bitcoin has changed since the time it was acquired. Thus, if a taxpayer bought 1 Bitcoin for $500, and later used 1 Bitcoin to purchase a TV when Bitcoin was trading at $600, the taxpayer has a taxable gain of $100.

- This part of the Notice has attracted some criticism from several commentators. A New York Times article summarized this critique, noting that characterizing Bitcoin as property "could discourage the use of Bitcoin as a payment method. If a user buys a product or service with Bitcoin, for example, the IRS will expect the individual to calculate the change in value from the date the user acquired the Bitcoin to the date it was spent. That would give the person a basis to calculate the gains—or losses—on what the IRS is now calling property." This criticism is partially justified, although the result would have generally been the same had the IRS decided to classify Bitcoin as a foreign currency. Under current law, U.S. taxpayers whose functional currency is the U.S. dollar (practically all U.S. taxpayers), must track their basis in any foreign currency they hold, and recognize exchange gain or loss as soon as they dispose of the currency, but only to the extent their exchange gain or loss exceeds $200. Thus, the criticism might have some merit, as capital gains or losses are taxed from the first dollar, while exchange gain or losses are subject to the $200 threshold. This could be corrected if a de-minimis threshold would be made applicable to Bitcoin transactions as well, but it is not clear that there is any legal basis for the IRS to do so. The only way to completely avoid taxation upon disposition of Bitcoin is to characterize it as a functional currency, which could only conceivably happen if the U.S. adopts Bitcoin as a legal tender. This is much to ask for, and certainly not within the power of the IRS to decide.

(3) Since taxes are paid in U.S. dollars and not in Bitcoin, the Bitcoin value must be converted to U.S. dollars for purposes of determining gains and losses. Fair market value is determined by reference to the BTC/USD price quoted in an online exchange if "the exchange rate is established by market supply and demand." The problem with this determination is that there are multiple such exchanges, and the BTC/USD spot price may vary significantly among such exchanges. In March, 2013, the price difference between various exchanges varied by as much as $100, for an average trading price across exchanges of about $575. Taxpayers could cherry-pick their BTC/USD exchange rate and reduce tax gains or increase tax losses. The Notice prescribes that BTC to USD conversion must be made "in a reasonable manner that is consistently applied." It is not clear what "consistency" means in this context and more guidance on this issue is needed.

(4) Mined Bitcoins are includable in gross income, and thus taxed, upon receipt. Bitcoins come into existence by a mining process. "Miners" use their computing resources to validate Bitcoin transactions, and in return are compensated with newly created Bitcoin. Unsurprisingly, the IRS concluded that such income is taxable upon receipt.

- The IRS did not explicitly rule on the character of mining income, but it is most likely ordinary, under several possible theories: (a) It is income from services – Miners are paid in newly generated Bitcoin for handling the bookkeeping of the Bitcoin public ledger. The IRS describes mining income as income received from using "computer resources to validate Bitcoin transactions and maintain the public Bitcoin transaction ledger." This may imply that the IRS views mining income as income from the provision of services. (b) It is wagering income – from a technical point of view mining is guessing the correct answer to a complex cryptographing problem. (c) Mining pools – most miners mine through mining pools, where multiple individual miners pool together their computing resources in order to generate Bitcoins. Mining pools might be classified as partnerships for tax purposes. If the mining pool is a partnership – the mining pool itself is clearly in the business of mining Bitcoins. Any income from a

trade or business of the partnership (the pool) passes through as ordinary income to the partners (the miners). If the mining pool is not a partnership – miners essentially rent out their computing capacity to the mining pool's operator. Rental income is ordinary income.

Information reporting and backup withholding. The Notice, as expected, also concludes that payments in Bitcoins are subject to information reporting and backup withholding. Thus, a person who in the course of trade or business makes Bitcoin payments in excess of $600 to a non-exempt U.S. person, must report such payments to the IRS and to the recipient on the applicable Form 1099. The payments are also subject to backup withholding to the extent the payor is unable to solicit the requisite tax information from the payee.

- This interpretation is perfectly reasonable, but its practical significance is left to be seen. The U.S. information reporting system is built, among others, on the assumption that parties to a taxable transaction know each other (or can reasonably obtain information about one another and send information to each other). As such, for example, taxpayers can send Forms 1099 to each other. The operation of Bitcoin defeats this assumption. Bitcoin is specifically designed to allow for exchange of value without having the parties to a transaction ever know each other. In fact, a Bitcoin payor is not always in a position to know whether payments he or she makes are made to the same person, or to different people. Payors may have a hard time even deciding whether the $600 threshold is met. The default is backup withholding. It is not clear, however, how the IRS can enforce reporting and withholding requirements when both parties to a transaction are anonymous both to the IRS and to each other. The ramifications may be significant. Consider for example mining pools. In order to be in compliance, U.S. based mining pools would have to identify their participants by name (rather than by anonymous address), a result that the Bitcoin community is all but certain to dislike. The alternative – backup withholding by the pool operator in respect of the Bitcoin mined – would probably drive Bitcoin miners to mining pools operated by non-U.S. taxpayers. It will be interesting to see how these requirements pan out.

Unaddressed issues. The IRS is well aware of the limited breadth of the Notice and it has solicited comments from taxpayers. Some specific issues not addressed by the Notice that may be of significance are as follows: (1) Whether Bitcoin and Bitcoin-wallets are financial assets and financial accounts, respectively, for purposes of FATCA and FBAR reporting requirements. This may not be of immediate relevance to most taxpayers due to the dollar amount thresholds applicable in such contexts, but as Bitcoin grows in popularity, such issues may become relevant. (2) Whether Bitcoin service providers (such as wallet service providers, Bitcoin exchanges, Bitcoin mining pools and so on) are financial institutions for reporting, withholding, and FATCA purposes. (3) Whether Bitcoin mining pools are entities for tax purposes. Some Bitcoin mining pools may conceivably be classified as entities separate from their owners for tax purposes, and as such may qualify as partnerships. This may carry with it significant tax consequences to Bitcoin miners. (4) Can Bitcoin be classified as a commodity for purposes of section 475(e), allowing dealers to elect mark-to-market accounting?

Summary. The IRS guidance is clear, concise, and correct on the law. While some obscurities remain, most major interpretative issues are addressed. The Notice does an excellent job explaining how transactions involving Bitcoin are taxed. It got all of the substantive issues right. In the context of information reporting, however, the Notice exposes the limitations of current tax law when it comes to collecting tax on Bitcoin transactions. While the IRS got the information reporting part right as well, the practical ability of the IRS to enforce such requirements may be limited in certain contexts. The main challenge remains in the area of collection. Time will tell whether the arsenal at the disposal of the IRS is enough to deal with tax evasion through Bitcoin, or whether Congress will have to supply the IRS with additional ammo.

b. Are virtual currency accounts reportable on the FBAR? In an IRS webinar broadcast on June 4, 2014, an IRS program analyst in the Small Business/Self Employed Division stated that the IRS and the Treasury Department's Financial Crimes Enforcement Network (FinCen) have "been closely monitoring developments around virtual currencies" such as Bitcoin. However, "for right now, FinCen has said that virtual currency is not going to be reportable on the FBAR, at least for this filing season. That could change in the future, as we monitor what's happening with virtual currencies … ." See *Virtual Currency May Be Reportable on FBAR in Future*, 2014 TNT 108-2

(6/5/14). More recently, according to the Journal of Accountancy, the AICPA Virtual Currency Task Force reached out to FinCEN regarding this issue, and

> FinCEN responded that regulations (31 C.F.R. § 1010.350(c)) do not define virtual currency held in an offshore account as a type of reportable account. Therefore, virtual currency is not reportable on the FBAR, at least for now.

Kirk Phillips, *Virtual currency not FBAR reportable (at least for now)*, J. Accountancy (6/19/19).

c. The IRS has announced a virtual currency compliance campaign. On July 2, 2018, the IRS announced on its website as one of five large business and international compliance campaigns a virtual currency campaign. The website describes the campaign as follows:

> The Virtual Currency Compliance campaign will address noncompliance related to the use of virtual currency through multiple treatment streams including outreach and examinations. The compliance activities will follow the general tax principles applicable to all transactions in property, as outlined in Notice 2014-21. The IRS will continue to consider and solicit taxpayer and practitioner feedback in education efforts, future guidance, and development of Practice Units. Taxpayers with unreported virtual currency transactions are urged to correct their returns as soon as practical. The IRS is not contemplating a voluntary disclosure program specifically to address tax non-compliance involving virtual currency.

d. The IRS has begun sending letters to taxpayers with virtual currency transactions who potentially failed to report their transactions properly. IR-2019-132 (7/26/19). The IRS announced that it has begun sending letters to taxpayers with virtual currency transactions who potentitally failed to report income or otherwise report the transactions properly. The IRS expected tht more than 10,000 taxpayers would recive the letters by the end of August 2019. The IRS urged those receiving the letters to take them very seriously and to take corrective action by amending returns and paying any tax and penalties due. The announcement stated that the "[t]he names of these taxpayers were obtained through various ongoing IRS compliance efforts."

e. If you are dealing with hard forks or airdrops of virtual currency you will want to read this revenue ruling. Rev. Rul. 2019-24, 2019-44 I.R.B. 1004 (10/9/19). This revenue ruling addresses whether a taxpayer has gross income as a result of either: (1) a hard fork of a cryptocurrency the taxpayer owns if the taxpayer does not receive units of a new cryptocurrency, or (2) an airdrop of a new cryptocurrency following a hard fork if the taxpayer receives units of new cryptocurrency. The ruling provides definitions of a hard fork and an airdrop, which are very technical and require a detailed undertanding of the mechanisms through which virtual currency transactions are carried out. The ruling concludes that a taxpayer does not have gross income in the first situation but does have gross income in the second.

f. The draft Schedule 1 for the 2019 Form 1040 asks about virtual currency transactions. On October 10, 2019, the IRS released a draft of Schedule 1 (Additional Income and Adjustments to Income) for the 2019 individual income tax return on Form 1040. The revised Schedule 1 asks the following question at the top of the form: "At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?"

2. ♫♪ We're off to see the wizard, the wonderful wizard of QOZ! ♪♫ The 2017 Tax Cuts and Jobs Act, § 13823, added §§ 1400Z-1 and 1400Z-2 to the Code relating to qualified opportunity zones ("QOZs") and qualified opportunity funds ("QOFs"). New §§ 1400Z-1 and 1400Z-2 are designed to encourage investors to free up capital and invest in economically distressed census tracts (i.e., QOZs) by providing federal income tax benefits to taxpayers who realize capital gains and invest them in certain funds (i.e., QOFs) that in turn invest in businesses and real estate located in these designated communities. More than 8,700 census tracts have been designated as QOZs. There are designated QOZs in all 50 states, the District of Columbia, and several U.S. territories. These QOZs are listed by state in Notice 2018-48, 2018-28 I.R.B. 9 (6/20/18) (as updated by Notice 2019-42, 2019-29 I.R.B. 352 (6/25/19)). In October 2018, Treasury published its first set of proposed regulations

under §1400Z-2 (REG-115420-18, Investing in Qualified Opportunity Funds, 83 F.R. 54279 (10/29/18), and published a second set of proposed regulations in May 2019 (REG-120186-18, Investing in Qualified Opportunity Funds, 84 F.R. 18652 (5/1/19). These two sets of proposed regulations are generally proposed to be effective on the date they are published as final regulations, but taxpayers can rely on the them before that date if applied in their entirety and in a consistent manner. New §§ 1400Z-1 and 1400Z-2 are effective December 22, 2017. To satisfy this effective date, it appears that the qualified reinvestment in a QOF must take place after December 22, 2017. *See "Opportunity Zones FAQs"*at www.irs.gov. A valuable resource for information concerning QOZs is the Economic Innovation Group at https://eig.org/opportunityzones.

- **Note:** This outline discusses the tax treatment of *investing* in a QOF, and does not address the requirements for a fund to have the status of a QOF. A QOF must be in the form of a partnership or corporation. The rules for qualifying such an entity as a QOF are detailed, technical, lengthy, and complex. In order to qualify, the entity must self-certify by filing Form 8996 ("Qualified Opportunity Fund"). It is beyond the scope of this outline to provide detailed coverage of the myriad of technical rules that a partnership or corporation must satisfy in order to be classified as a QOF. With the reported proliferation of QOFs, investors will need to use due diligence to determine whether they can rely on the representations by the fund organizers and promoters that the funds actually meet all of the technical requirements of a QOF. In addition, investors should use due diligence when analyzing whether investing in any particular QOF is economically advisable.

Taxpayers Eligible To Use § 1400Z-2. The tax benefits of investing in a QOF are set forth in § 1400Z-2. Virtually any type of taxpayer having a qualifying capital gain ("eligible gain") may qualify for the tax benefits provided by § 1400Z-2, including: individuals, C corporations (including regulated investment companies and real estate investment trusts), partnerships, S corporations, and trusts and estates. Prop. Reg. § 1.1400Z2(a)-1(b)(1). The preamble to the proposed regulations states that eligible taxpayers also include common trust funds described in § 584 as well as qualified settlement funds, disputed-ownership funds, and other entities taxable under the § 468B regulations.

Overview of Tax Incentives for Investing in "Qualified Opportunity Funds"(QOFs). The tax incentives provided by § 1400Z-2 are summarized briefly below.

(1) *Deferral of Capital Gain To Extent Invested in QOF Within 180 Days.* Generally § 1400Z-2 allows taxpayers to defer capital gains (long-term or short-term) to the extent the gains are invested in a QOF within 180 days of realizing the capital gain.

(2) *Investment In QOF Held For At Least 5 Years - 10% Exclusion.* If the investment in the QOF is held for at least five years, then the taxpayer can exclude from gross income 10 percent of the original deferred capital gain.

(3) *Investment In QOF Held For At Least 7 Years - Additional 5% Exclusion.* If the investment in the QOF is held for at least seven years, then the taxpayer can exclude from gross income an additional 5 percent of the deferred capital gain *for a total exclusion of 15 percent of the original deferred capital gain*. Because gain deferred under § 1400Z-2 is taxed upon the earlier of the date the investment in the QOF is sold (or disposed of in a taxable transaction) or December 31, 2026, a taxpayer must invest in a QOF by December 31, 2019, to meet the seven-year holding period and thereby receive the additional 5 percent exclusion.

(4) *Remaining Deferred Capital Gain Taxed No Later Than December 31, 2026*. Any remaining deferred capital gain is generally taxed on the earlier of: (1) the date the investment in the QOF is sold (or disposed of in a taxable transaction), or (2) December 31, 2026.

(5) *Investment In QOF Held For At Least 10 Years – Post-Acquisition Gain Excluded from Income*. For qualified investments in a QOF held for at least 10 years, the taxpayer may elect to exclude from gross income any gain from *post-acquisition appreciation* (i.e., may elect to increase the basis of the fund to the fair market value of the fund on the date the investment in the fund is sold or exchanged).

Acquisition of a Qualifying QOF Interest. The discussion of investment in QOFs discussed in this outline assumes that the taxpayer invested cash in the QOF, because it is generally presumed that

the vast majority of investments in QOFs will be in cash. However, the proposed regulations provide detailed guidelines for how these rules would operate if the taxpayer transferred non-cash property in return for a qualifying QOF interest. See Prop. Reg. § 1.1400Z2(a)-1(b)(9). A taxpayer may not acquire a qualifying QOF interest in return for providing *services* to the QOF. Prop. Reg. § 1.1400Z2(a)-1(b)(9)(ii). A taxpayer can acquire a qualifying QOF interest from someone other than the QOF. Prop. Reg. § 1.1400Z2(a)-1(b)(9)(iii).

Qualifying Capital Gains Eligible for Deferral and or Exclusion. The requirements for capital gains to be eligible for deferral or exclusion are summarized below.

(1) *"Capital" Gains Eligible For Deferral Treatment Under § 1400Z-2.* Prop. Reg. § 1.1400Z2(a)-1(b)(2) provides that a gain eligible for deferral or exclusion treatment under § 1400Z-2 ("eligible gain") is generally a gain that: (1) is "treated as capital" for federal income tax purposes; (2) would otherwise have been recognized for federal income tax purposes before January 1, 2027, except for the deferral under § 1400Z-2, and (3) does not arise from a sale or exchange with a "related party." The preamble to the proposed regulations provides that even the "capital gain" portion (if any) of a dividend would generally qualify for deferral treatment under § 1400Z-2. See Prop. Reg. § 1.1400Z2(a)-1(b)(4)(ii)(B), Example 2 for an example of the treatment of a capital gain dividend.

- Although all gains treated as "capital gains" under the Internal Revenue Code will generally be "eligible gains," there are certain limitations on capital gains from § 1256 contracts and other gains that are part of an "offsetting-position" transaction. See Prop. Reg. § 1.1400Z2(a)-1(b)(2)(iii)(B) and -1(b)(2)(iv) for details.

(2) *Short-Term CapitalGains.* There is no prohibition for qualifying short-term capital gains. However, if a short-term capital gain is deferred by a qualifying investment in a QOF, when the deferred gain is ultimately recognized, it will retain its short-term capital gain treatment. Prop. Reg. § 1.1400Z2(a)-1(b)(5).

(3) *Gains Arising from a Sale to a "Related Party" Do Not Qualify.* For this purpose, persons are related to each other if they are described in § 267(b) or § 707(b), determined by substituting 20 percent for 50 percent wherever it appears in those sections. § 1400Z-2(e)(2).

(4) *Capital Gains to Owners Resulting from Operating or Liquidating Distributions from Their C Corporations, S Corporations, or Partnerships.* Generally, a capital gain is triggered under § 301 or § 731 if a C corporation, S corporation, or partnership makes an actual or deemed cash distribution in excess of the owner's basis in the stock or partnership interest. A capital gain from such a distribution should generally be an "eligible gain"f or purposes of deferral under § 1400Z-2. However, if the distributee-owner and the distributing entity meet the 20 percent ownership test for "related parties" discussed above (a fairly common situation), the gain on the distribution would not qualify for deferral.

(5) *Capital Gains Under § 1231.* Prop. Reg. § 1.1400Z2(a)-1(b)(2)(iii) states: "*The only gain arising from section 1231 property* that is eligible for deferral under section 1400Z-2(a)(1) is *capital gain net income* for a taxable year. This net amount is determined by taking into account the capital gains and losses for a taxable year on all of the taxpayer's section 1231 property. The *180-day [Reinvestment] Period .....* with respect to *any capital gain net income from section 1231 property* for a taxable year *begins on the last day of the taxable year."* (Emphasis added.)

(a) *Property Subject to § 1231.* Generally, § 1231 gains and losses arise from the sale or exchange or compulsory or involuntary conversion of "property used in a trade or business." Section 1231(b)(1) generally defines "property used in a trade or business" as property used in a trade or business that is held for more than one year that is either: (1) subject to the allowance for depreciation under § 167, or (2) real property. However, this category also includes: timber held for more than one year where the taxpayer elects to treat the cutting as a sale and timber sold with a retained economic interest under § 631; coal or domestic iron ore sold with a retained economic interest as described under § 631; certain livestock; and certain unharvested crops.

(b) *Section 1231 Tax Treatment.* If, for the tax year, a taxpayer's total § 1231 gains from sales or exchanges (i.e., those in the so-called "main hotchpot") exceed the taxpayer's total § 1231 losses, the gains are treated as long-term capital gains and the losses are treated as long-term capital losses. § 1231(a)(1). By contrast, if for the tax year a taxpayer's total § 1231 losses exceed the taxpayer's

§ 1231 gains, the gains are treated as ordinary income and the losses are treated as ordinary losses. As noted above, the proposed regulations provide that only a taxpayer's *"capital gain net income*" under § 1231 is eligible for deferral under § 1400Z-2(a)(1). The term *"capital gain net income"* seems to suggest that only the *"net"* § 1231 gain amount is eligible for deferral. Assuming this interpretation is correct, if for the tax year a taxpayer had a *single § 1231 gain of $100* and a *single § 1231 loss of ($80),* only the *net § 1231 gain* of *$20* ($100 less $80) would be eligible for deferral. However, since the entire § 1231 gain of $100 is a long-term capital gain under a literal reading of § 1231(a)(1), some have argued that the entire $100 should be available for deferral.

- Several professional groups have submitted comment letters to Treasury recommending that the final regulations clarify that once a taxpayer has a net § 1231 gain, then each *"gross"*§ 1231 gain ($100 in the above example) would be available for deferral if that amount is invested in a QOF. See *Practitioners Push Back on O-Zone Year-End Netting Rule*, Doc. 2019-25989, 2019 TNTF 129-1 (7/5/19).

(c) *180-Day Re-Investment Period For Net § 1231 Gains.* For any given tax year, whether a taxpayer has a net § 1231 gain (qualifying for deferral) cannot be determined until the end of the tax year. Consequently, as noted above, the proposed regulations provide that the 180-day reinvestment period to invest in a QOF with respect to a net § 1231 gain does not begin until the last day of the taxable year. Practice Alert! If, for example, a calendar-year taxpayer has only a single gain from the sale of a § 1231 asset during 2019, the earliest the taxpayer could purchase a qualifying interest in a QOF in order to defer the net § 1231 gain would be December 31, 2019. Presumably, unless we get further guidance on this issue, the taxpayer in this example would have to wait until December 31, 2019 to reinvest in the QOF even if the taxpayer knew in advance that there would be no § 1231 losses during the remainder of the year.

- Several professional organizations (e.g., AICPA, ABA, State Bar of Texas Tax Section) have submitted comments to Treasury recommending that the final regulations provide a more flexible 180-day period for § 1231 gains. For example, several of the comments recommended an option to start the 180-day period on the date of the sale of the § 1231 property (particularly if the taxpayer was able to predict with some certainty that it would end up with a net § 1231 gain by the end of the year). See Stephanie Cumings, *Practitioners Push Back on O-Zone Year-End Netting Rule*, Doc. 2019-25989, 2019 TNTF 129-1 (7/5/19).

(d) *Section 1231Gains Generated By PartnershipsAnd S Corporations.* Net § 1231 gains and losses generated by a pass-through entity (e.g., a partnership or S corporation) pass through to the owners as "separately stated" items. The owners (partners and S corporation shareholders) then combine the net § 1231 gains/losses that pass through with their own § 1231 gains/losses to determine whether they have an overall net § 1231 gain or a net § 1231 loss on their individual returns. Consequently, even if the pass-through entity has a net § 1231 gain at the entity level, it is entirely possible that the net § 1231 gain passing through to the owner, when combinedwith the owner's separate § 1231 losses, could ultimately be taxed to the owner as a "net" § 1231 loss.

- This treatment of net § 1231 gain passed through by a partnership or S corporation raises a question as to whether a partnership or an S corporation can make the election at the entity level to defer the net § 1231 gain (determined at the entity level) by investing in a QOF. According to media reports on the ABA Tax Section's May meeting, Bryan Rimmke an Attorney-Adviser in Treasury's Office of Tax Legislative Counsel, stated the following at the meeting (on May 10, 2019) -"the government allows a partnership to net its gains against its losses for section 1231 purposes, and if it ends up with a net gain, the partnership can elect to invest that gain into a qualified opportunity fund." It was reported that Mr. Rimmke agreed that this netting of § 1231 gains and losses at the partnership level is allowed for purposes of reinvesting the net gain in a QOF "[e]ven if a partnership doesn't have a per se [section] 1231 netting." See Eric Yauch, *Partnerships Can Defer Section 1231 Gain Under O-Zone Rules*, Doc. 2019-18716, 2019 TNT 92-9 (5/13/19). Hopefully the IRS will provide clear guidance on this issue in the final regulations.

(e) *Impact Of Recapture Rules On Eligible § 1231 Gain.* If, and to the extent, a net § 1231 gain is recharacterized as ordinary income under the depreciation recapture provisions of

§ 1245 or § 1250, or under the 5-year look-back rule under § 1231(c), the ordinary income portion would not be eligible for deferral under § 1400Z-2.

- Section 1231(c) generally provides that a taxpayer's net § 1231 gain for the current year will be recharacterized as ordinary gain to the extent of the taxpayer's net § 1231 losses recognized in the preceding 5 years. However, § 1231(c) is a § 1231 loss "look-back" rule, not a § 1231 loss "look-forward" rule. To illustrate, assume that for 2019 a taxpayer: (1) has had no net § 1231 losses in the preceding 5 years, (2) in 2019 has already recognized a single § 1231 gain of $100, and (3) is now considering selling a single § 1231 asset for a loss of ($90). If the taxpayer sells the § 1231 loss asset before the end of 2019 generating a § 1231 loss of ($90), the taxpayer would have a "net" § 1231 gain for 2019 of $10 ($100 less $90) which would qualify for deferral under § 1400Z-2. However, if the taxpayer waits until 2020 to recognize the § 1231 loss of ($90), she will have a net § 1231 gain for 2019 of $100 eligible for deferral under § 1400Z-2. Moreover, if taxpayer has no other §1231 transactions in 2020 other than the § 1231 loss of ($90), she would then be able to deduct fully the ordinary loss of ($90) against all other 2020 income. In this situation, the 5-year look-back rule under § 1231(c) would not apply to 2020 because that rule applies only when there are net § 1231 losses reported in the preceding 5 years.

General Tax Benefits of Investing in Qualified Opportunity Funds (QOFs). The tax benefits provided by § 1400Z-2 for those investing in QOFs are described in more detail below.

(1) *Gain Deferral Benefits Under § 1400Z-2*. A taxpayer may defer recognition of a qualifying capital gain by investing the *amount of the gain* in a QOF within 180 days of realizing the capital gain. For example, assume that a taxpayer sold a capital asset for $100 with a basis of $10 (realizing a $90 qualifying capital gain). The taxpayer could defer 100 percent of the $90 capital gain by investing $90 (i.e., the amount of the gain) in a QOF within 180 days. The initial basis of the QOF investment acquired as a result of the reinvestment of the taxpayer's qualified capital gain is zero. § 1400Z-2(b)(2)(B)(i). So, in the above example,the taxpayer's initial basis in the QOF investment is zero, even though the taxpayer paid $90 for it.

(a) *Maximum Period Of Gain Deferral*. The deferred gain (e.g., $90 in the above example) must be recognized on the earlier of: (1) December 31, 2026 (whether or not the taxpayer sells the QOF interest), or (2) the date the taxpayer sells or exchanges the interest in the QOF. § 1400Z-2(b)(1).

(b) *Maximum Gain Recognized When Deferred Gain Triggered.* When the deferred gain is triggered, the maximum amount of deferred gain that will be recognized is the lesser of: (1) the amount of gain originally deferred, or (2) the fair market value of the QOF investment as determined on the recognition date, OVER the taxpayer's basis in the QOF investment. § 1400Z- 2(b)(2)(A). Again using the above example, assume that after four years the taxpayer sold the QOF investment for $75. This would result in a deferred gain of only $75 being riggered even though the original deferred gain was $90. This generally means that, if on the recognition date the value of the QOF interest has dropped below the initial investment amount in the QOF interest (e.g., in the above example that would be below $90), the amount of the deferred gain recognized will generally be reduced by the post-acquisition loss in value.

(2) *Reduction Of Deferred Gain Based On 5- Or 7-Year Holding Periods.* As mentioned previously, after the taxpayer holds the QOF investment for at least five years, 10 percent of the deferred gain will be excluded from the taxpayer's gross income. If the QOF investment is held at least seven years, then an additional 5 percent (a total of 15 percent) of the deferred gain will be excluded from the taxpayer's gross income. This exclusion results from the taxpayer getting an automatic increase in the basis of the QOF interest of 10 percent of the deferred gain at five years and an additional increase of 5 percent at seven years. § 1400Z-2(b)(2)(A); § 1400Z-2(b)(2)(B)(iii) and (iv). Again using the above example, after the taxpayer has held the QOF investment for five years, her basis goes from zero to $9 (i.e., 10% of the deferred gain of $90), and after holding it for seven years her basis goes to $13.50 (i.e., 15% of the deferred gain of $90). As noted earlier, because gain deferred under § 1400Z-2 is taxed upon the earlier of the date the investment in the QOF is sold (or disposed of in a taxable transaction) or December 31, 2026, a taxpayer must invest in a QOF by December 31, 2019, to meet the seven-year holding period and thereby receive the additional 5 percent exclusion.

- *Impact of Potential Increases in Capital Gains Tax Rates.* Even in the best case scenario, 85 percent of the original deferred capital gain will be taxed no later than December 31,

2026, at whatever capital gains rates exist in 2026. If the current effective maximum long-term capital gain rate of 23.8% is increased between now and 2026, the increase in the capital gains rates would dilute the tax benefit of the tax deferral. Assuming a 15 percent deferred gain exclusion, it would appear that the top effective capital gain rate would have to be increased to above 28% (i.e., 28% x 85% equals 23.8%) before the top effective rate would be greater than the current top effective capital gain rate of 23.8%.

(3) *100% Gain Exclusion After Holding QOF for 10 Years.* After the taxpayer holds the QOF investment for at least ten years, the taxpayer can exclude 100 percent of the gain realized from the sale or exchange of the QOF interest. This gain, in essence, represents the appreciation that occurred in the QOF investment after the taxpayer purchased it. To receive the benefit of this exclusion, the taxpayer must sell the interest in the QOF before 2048. Prop. Reg. § 1.1400Z2(c)-1(b). To illustrate, recall in the above example the taxpayer sold a capital asset for $100 with a basis of $10 (realizing a $90 qualifying capital gain), and deferred the gain by investing $90 in a QOF within 180 days. If the taxpayer holds the QOF investment for at least 10 years, sells it for $150, and elects to step the basis up to the fair market value of the QOF investment on the date of the sale as provided in § 1400Z-2(c), the taxpayer could exclude 100 percent of the $60 gain (i.e., sales proceeds of $150 less the initial investment of $90 in the QOF). § 1400Z-2(c).

(a) *Generally No TaxableGain Triggered on Investment in QOF After 10-Year Holding Period.* The sale, exchange, or other disposition of a QOF investment (acquired solely to defer previous gain) that is held by the taxpayer for at least ten years should not trigger any taxable gain because: (1) all of the initial deferred gain reflected in the investment in a QOF must be fully recognized no later than December 31, 2026, and (2) 100 percent of the post-acquisition gain is excluded if the QOF investment is held at least ten years.

(b) *10-Year Rule Applies Only to QOF Investment That Allowed Taxpayer to Defer Initial Capital Gain.* The only portion of the investment in the QOF that qualifies for this 100 percent gain exclusion is the portion of the investment that allows the taxpayer to defer a previous capital gain. If a taxpayer invests in a QOF, and only a portion of the investment is used to defer a previous capital gain, then the investment in the QOF will be treated as two separate investments. § 1400Z-2(e)(1). For example, again recall the facts in the previous hypothetical where the taxpayer sold a capital asset for $100 with a basis of $10 (realizing a $90 qualifying capital gain). Assume further that the taxpayer used the entire sales proceeds of $100 to purchase an interest in a QOF for $100. In that event: (1) the QOF interest representing $90 of the purchase price (i.e., the amount of gain deferred) will be treated as a separate QOF investment and can qualify for the 100 percent exclusion if held at least ten years, and (2) the QOF interest representing $10 of the purchase price will likewise be treated as a separate QOF investment but will not qualify for the 100 percent exclusion. *See also* Prop. Reg. § 1.1400Z2(a)-1(b)(10). In this example, although the separate QOF investment represented by the $90 will qualify for the 10 percent to 15 percent bump up in basis if held five or seven years, the separate QOF investment represented by the $10 will not qualify for any basis bump. Thus, an investor who simply invests in a QOF (without attempting to use the investment to defer previously-realized capital gain) will receive no special tax treatment under § 1400Z-2 when the investor later sells the QOF interest.

(c) *QOF's Sale Of "Qualifying Ozone Business Property"After 10 Years.* Generally, § 1400Z-2 allows a taxpayer who has met the ten-year holding period requirement to exclude 100 precent of the gain resulting from the sale of the taxpayer's QOF interest. Thus, for example, if a taxpayer meeting the ten-year holding period requirement sold S corporation stock or a partnership interest in an entity that was a QOF and elected to step up the basis to fair market value, the entire gain would be excluded. Moreover, it appears that the entire gain on the sale a QOF partnership interest would be excluded even if the partnership held so-called "hot assets"under § 751(a). See Prop. Reg. § 1.1400Z2(c)-1(b)(2)(i) for details.

- *Sale Of Assets By QOF.* The proposed regulations provide special rules for allowing an investor to exclude pass-through "capital gains" and pass-through "capital gain net income from § 1231 property" triggered by a QOF selling its qualifying ozone business property after the ten-year holding period. See Prop. Reg. § 1.1400Z2(c)-1(b)(2)(ii) for details. *Note:* Even if the ten-year holding period is satisfied, it appears that the QOF investor could not exclude pass-through ordinary gain (e.g., §1245/1250 depreciation recapture gain, cash-basis receivables, inventory gain, etc.) from the sale of the assets by the QOF. Consequently, if the investor sells an ownership interest in a QOF (S corporation stock

or partnership interest) after meeting the ten-year holding period requirement, the taxpayer can exclude 100 percent of the gain. By contrast, if the QOF sells the assets of the business, any ordinary income passing through to the QOF investor will be fully taxed.

(4) *Gain Triggered On Disposition of Entire Interest in QOF May Be Deferred if Reinvested in QOF Within 180 Days, But Reinvestment Starts New Holding Period.* The preamble to the proposed regulations states:

> If a taxpayer acquires an original interest in a QOF in connection with a gain-deferral election under section 1400Z-2(a)(1)(A), if a later sale or exchange of that interest triggers an inclusion of the deferred gain, and if the taxpayer makes a qualifying new investment in a QOF, then the proposed regulations provide that the taxpayer is eligible to make a section 1400Z-2(a)(2) election to defer the inclusion of the previously deferred gain. Deferring an inclusion otherwise mandated by section 1400Z-2(a)(1)(B) in this situation is permitted only if the taxpayer has disposed of the entire initial investment ..... ."

The preamble also provides:

> [I]f an investor disposes of its entire qualifying investment in QOF 1 and reinvests in QOF 2 within 180 days, the investor's holding period for its qualifying investment in QOF 2 begins on the date of its qualifying investment in QOF 2, not on the date of its qualifying investment in QOF 1.

"Inclusion Events" That Trigger Deferred Gain. The events that trigger recognition of a taxpayer's deferred gain are described below.

(1) *Deferred Gain "Inclusion Events."* Section 1400Z-2(b)(1)(A) generally requires the deferred gain to be recognized if the investment in the QOF is "sold or exchanged" before December 31, 2026. (*Note:* The following "inclusion events" are relevant only for the deferred gain through December 31, 2026, because any deferred gain remaining after application of the five and seven year exclusion rules must be recognized no later than December 31, 2026 even if the taxpayer is still holding the QOF investment.) Prop. Reg. § 1.1400Z2(b)-1(c) includes a long list of transactions (called "inclusion events") that trigger all or a portion of the deferred gain reflected in an investment in a QOF. The list of "inclusion events"is long, technical, detailed, and the following is merely an overview of selected provisions.Generally, the"inclusion events"under the proposed regs fall into two categories: (1) certain transactions that reduce the taxpayer's equity interest in the QOF, and (2) certain distributions of property from the QOF.

(a) *Overview Of "Equity Reductions" In Taxpayer's Interest In QOF That Could Trigger Deferred Gain.* Transactions that reduce a taxpayer's equity interest (directly or indirectly) in the QOF that could trigger all or a portion of the deferred gain include: (1) dispositions of all or a portion of an interest in a QOF by sale or exchange; (2) disposition by gift (even if the donee is a tax exempt organization); (3) liquidation of the QOF; (4) certain liquidations of an owner of an interest in a QOF; (5) disposition of an interest in a partnership that is an owner in a QOF; and (6) an aggregate change in ownership in excess of 25 percent of an S corporation that holds an interest in a QOF.

- The proposed regulations also provide that the deferred gain will be triggered if a taxpayer claims a worthlessness deduction under § 165(g) with respect to a qualifying QOF investment. Prop. Reg. § 1.1400Z2(b)-1(c)(1)(i).

(b) *Overview Of Certain Distributions Of Property That Could Trigger Deferred Gain.* An inclusion event could occur whenever there is an actual or deemed distribution of property (including cash) by a QOF partnership or corporation where the distributed property has a FMV in excess of the taxpayer's basis in the QOF partnership or corporation. Prop. Reg. § 1.1400Z2(b)-1(c)(6)(iii). This could include a distribution from a QOF corporation or partnership that exceeds the owner's basis and is thus taxed as a sale or exchange under §§ 301, 731, or 1368.

(c) *More Details On Inclusion Events.* Please see Prop.Reg. § 1.1400Z2(b)-1(c) for additional details, including a complete list of inclusion events.

(2) *Overview Of Certain Transactions That Do Not Trigger Deferred Gain.* The proposed regulations also identify transactions that generally are not inclusion events, including: (1) certain transfers of an investment in a QOF upon the death of a taxpayer (however, the deferred gain is treated as income in respect of a decedent under § 691 when triggered, but the recipient receives the decedent's holding period in the QOF for purposes of the 5/7/10 year rules); (2) the contribution of an ownership interest in a QOF to a grantor trust; (3) § 721 contributions (i.e., contributions of property to a partnership in exchange for a partnership interest); (4) the election, revocation, or termination of S corporation status. Please see Prop. Reg. § 1.1400Z2(b)-1(c) for additional details, including a complete list of events that are not inclusion events.

- If certain rigid requirements are satisfied, a QOF may be able to sell all or a portion of its qualifying opportunity zone property without triggering a penalty on the QOF for failing to invest 90% of its assets in qualified OZ property if the proceeds are reinvested in qualifying opportunity zone property during a 12-month testing period. See § 1.1400Z2(f)-1(b) for details. However, it appears under the proposed regulations that any gain (including capital gains) recognized by the QOF on the sale and reinvestment of its qualified opportunity zone property will pass through and be taxed to an investor in the QOF who hasn't held his or her interest for at least 10 years. As previously discussed, if the investor has held the QOF interest for at least 10 years, the pass-through capital gains or net § 1231 gains generated by the QOF should be tax-free to the investor.

Timing and Reporting Requirements for Deferred Gains Invested In a QOF. The timing and reporting requirements for deferred gains invested in a QOF are summarized below.

(1) *The 180-Day Reinvestment Requirement.* Generally, for an eligible capital gain to be deferred under § 1400Z-2, the taxpayer must purchase a qualifying investment in a QOF no later than 180 days following the date of the sale or exchange, or other disposition that generated the eligible gain. § 1400Z-2(a)(1)(A). However, the proposed regulations provide that generally the first day of the 180-day period is the date on which the gain would be recognized for federal income tax purposes, without regard to the deferral available under § 1400Z-2. There are at least two examples where the starting date of the 180-day period begins after the date of the sale or exchange: (1) Net §1231 Gains - as discussed above, and (2) Pass-Through Entities - if a partnership or S corporation has an "eligible gain," the pass-through entity may elect to defer the gain and invest in a QOF within 180 days of the disposition. However, if the pass-through entity does not elect to defer the gain, each owner has the option to elect to defer the owner's respective portion of the pass-through eligible gain by directly investing in a QOF. In this latter situation, the beginning of the 180-day period for the owners generally begins on the last day of the pass-through entity's tax year. Please see Prop. Reg. § 1.1400Z2(a)-1(c) for details.

(2) *Election Mechanics - Form 8949.* A taxpayer must affirmatively elect to defer an eligible gain by making the election on Form 8949. The election is generally made on Form 8949 ("Sales and Other Dispositions of Capital Assets") in accordance with the Form's instructions by reporting the eligible gain and entering "Z" in column (f). In addition, the instructions to the 2018 Form 8949 provide:

> If the gain is reported on Form 8949, do not make any adjustments for the deferral in column (g). Report the deferral of the eligible gain on its own row of Form8949 in Part I with box C checked or Part II with box F checked (depending on whether the gain being deferred is short-term or long-term). If you made multiple investments in different QO Funds or in the same QO Fund on different dates, use a separate row for each investment.

(3) *IRS Says Election To Defer Gain Can Be Made On An Amended Return.* On its website, the IRS answered this question in a segment entitled "Opportunity Zones FAQs" (at www.irs.gov.) – which contains the following Q&A: "Q. Can I still elect to defer tax on that gain if I have already filed my tax return? A. Yes, but you will need to file an amended return, using Form 1040-X and attaching Form 8949."

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. Some inflation-adjusted numbers for 2020. Notice 2019-59, 2019-47 I.R.B. 1091 (11/8/19).

- Elective deferrals in §§ 401(k), 403(b), and 457 plans are increased from $19,000 to $19,500 with a catch-up provision for employees aged 50 or older that is increased from $6,000 to $6,500.

- The limit on contributions to an IRA remains unchanged at $6,000. The AGI phase-out range for contributions to a traditional IRA by employees covered by a workplace retirement plan is increased to $65,000 to $75,000 (from $64,000-$74,000) for single filers and heads of household, increased to $104,000-$124,000 (from $103,000-$123,000) for married couples filing jointly in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, and increased to $189,000-$199,000 (from $193,000-$203,000) for an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered. The phase-out range for contributions to a Roth IRA is increased to $196,000-$206,000 (from $193,000-$203,000) for married couples filing jointly, and increased to $124,000-$139,000 (from $122,000-$137,000) for singles and heads of household.

- The annual benefit from a defined benefit plan under § 415 is increased to $230,000 (from $225,000).

- The limit for defined contribution plans is increased to $57,000 (from $56,000).

- The amount of compensation that may be taken into account for various plans is increased to $285,000 (from $280,000), and is increased to $425,000 (from $415,000) for government plans.

- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to $65,000 (from $64,000) for married couples filing jointly, increased to $48,750 (from $48,000) for heads of household, and increased to $32,500 (from $32,000) for singles and married individuals filing separately.

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

D. Individual Retirement Accounts

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

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

D. Deductions and Credits for Personal Expenses

1. Standard deduction for 2020. Rev. Proc. 2019-44, 2019-47 I.R.B. 1093 (11/6/19). The standard deduction for 2019 will be $24,800 for joint returns and surviving spouses (increased from $24,400), $12,400 for unmarried individuals and married individuals filing separately (increased from $12,200), and $18,650 for heads of households (increased from $18,350). For individuals who can be clained as dependents, the standard deduction cannot exceed the greater of $1,100 or the sum of $350 and the individual's earned income. The additional standard deduction amount for those who are legally blind or who are age 65 or older is $1,650 for those with the filing status of single or head of household (and who are not surviving spouses) and is $1,300 for married taxpayers ($2,600 on a joint return if both spouses are age 65 or older).

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

1. We humbly ask, "Does it ever make sense to hold real estate in an S corporation?" And, "Will taxpayers ever learn that a series of 'due tos' and 'due froms' with related entities doesn't amount to shareholder debt for purposes of subchapter S?" Meruelo v. Commissioner, 923 F.3d 938 (11th Cir. 5/6/19). The taxpayer was a shareholder of an S corporation that suffered nearly a $27 million loss after banks foreclosed on its condominium complex. The taxpayer contended that he had sufficient basis in the S corporation's indebtedness to him to absorb his $13 million share of the S corporation's loss. According to the taxpayer, his basis stemmed from his $5 million capital contribution to the S corporation plus more than $9 million of net indebtedness owed to various other business entities in which the taxpayer owned an interest. Essentially, the $9 million of indebtedness for which the taxpayer claimed basis was derived from netting the S corporation's accounts payable and accounts receivable with respect to other entities controlled by the taxpayer. The IRS contended, however, that the taxpayer could claim only $5 million in losses because the net indebtedness owed by the S corporation to the taxpayer's other business entities was not "bona fide indebtedness" that "runs directly" to the taxpayer. *See* § 1366; Reg. § 1.1366-2(a)(2)(i). The Tax Court had held in favor of the IRS, upholding the IRS's asserted deficiency of approximately $2.6 million, and the Eleventh Circuit, I an opinion by Judge Pryor, affirmed the Tax Court's decision. Judge Pryor acknowledged, as did the Tax Court, that under the right circumstances either the "back-to-back" loan theory (*see* Reg. § 1.1366-2(a)(2)(iii) Ex. 2) or the "incorporated pocketbook" theory (*see Yates v. Comm'r*, 82 T.C.M. (CCH) 805 (2001); *Culnen v. Comm'r*, 79 T.C.M. (CCH) 1933 (2000), *rev'd on other grounds*, 28 F. App'x 116 (3d Cir. 2002)) argued by the taxpayer can support a taxpayer-shareholder's claim of basis for S corporation debt owed to another party; however, the facts of the taxpayer's case were nothing like the facts in cases premised upon the "back-to-back" loan

theory or the "incorporated pocketbook" theory. There was no mention in Judge Pryor's opinion of the IRS's assertion of accuracy-related penalties against the taxpayer. *Perhaps the IRS has a heart after all . . . .*

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 § 754 *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. On October 29, 2019, the IRS released draft instructions for the 2019 Form 1065 and, on October 30, 2019, 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.

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. Has so-called "dark money" become virtually invisible (except to the IRS, of course)? Rev. Proc. 2018-38, 2018-31 I.R.B. 280 (07/16/18). Oversimplifying a bit for the sake of convenience, since 1969 § 6033(b)(5) has required § 501(c)(3) organizations to disclose on their annual information returns (Forms 990) certain contributions as well as "the names and addresses of [the organization's] substantial contributors" for the year. Section 507(d)(2) defines a "substantial contributor" as any person contributing $5,000 or more to an organization if such amount is greater than 2 percent of the total contributions to the organization during the taxable year. Section 1.6033-2 of the regulations extended this disclosure requirement to other types of organizations exempt under § 501(a), including § 501(c)(4) "social welfare" organizations and § 501(c)(6) "trade associations." In particular, some § 501(c)(4) social welfare organizations have been created and funded to engage in

lobbying and political campaign activity that is prohibited to § 501(c)(3) organizations. This use of § 501(c)(4) organizations has been termed "dark money" by some and is controversial. Although the names and addresses of "dark money" contributors were supposed to be redacted on the organization's Form 990 made publicly available by the IRS pursuant to § 6104(b), some inadvertent disclosures have occurred. Reportedly, a few of the largest organizations impacted have been entities affiliated with the National Rifle Association, the U.S. Chamber of Commerce, and Americans for Prosperity, the latter being tied to billionaires Charles and David Koch. *See* R. Rubin, "U.S. Treasury Restricts Donor Disclosure Requirement for Some Nonprofit Groups," Wall St. J. (July 16, 2018). After Rev. Proc. 2018-38, though, substantial contributors' names and addresses are no longer required to be disclosed on a non-(c)(3) organization's annual Form 990. As stated in the revenue procedure, "The IRS does not need personally identifiable information of [such] donors to be reported . . . in order for it to carry out its responsibilities. The requirement to report such information increases compliance costs for some private parties, consumes IRS resources in connection with the redaction of such information, and poses a risk of inadvertent disclosure of information that is not open to public inspection." The reporting changes announced by Rev. Proc. 2018-38 are effective for taxable years ending on or after December 31 2018. Notwithstanding this relief from disclosure granted to § 501(a) organizations other than (c)(3)s, Rev. Proc. 2018-38 states that the affected organizations must maintain donor information in the organization's books and records in case such information is requested by the IRS.

a. ♫♪This little light of mine, I'm gonna let it shine . . ."♪♫ Bullock v. Internal Revenue Service, ___ F.Supp.3d ___ (D. Mont. 7/30/19). In a suit brought by Governor Stephen Bullock (also a former Democratic candidate for President in 2020), the U.S. District Court for the District of Montana (Judge Morris) set aside Rev. Proc. 2018-38 for failure to comply with the Administrative Procedure Act ("APA"). Governor Bullock had argued that, although the Commissioner has discretion to determine whether the names and addresses of substantial contributors must be disclosed on annual information returns filed by exempt organizations other than (c)(3)s, the change announced in Rev. Rul. 2018-38 was a new "legislative rule." As such, Treasury and the IRS had to comply with the notice and comment procedures of the APA (which they did not do) before issuing Rev. Proc. 2018-38. Treasury and the IRS maintained that Rev Proc. 2018-38 was merely a "procedural rule," not a "legislative rule," so the APA's notice and comment requirements did not apply. Judge Morris disagreed and sided with Governor Bullock to hold that Treasury and the IRS should have complied with the APA before issuing Rev. Proc. 2018-38.

b. OK, you win for now. We'll go over to the "Darkside" soon. REG-102508-16, Guidance Under Section 6033 Regarding the Reporting Requirements of Exempt Organizations, 84 F.R. 47447 (9/10/19). Apparently believing that Governor Bullock had a valid point, Treasury and the IRS have issued proposed regulations under § 6033 that ultimately will implement the guidance set forth in Rev. Proc. 2018-38: generally, only § 501(c)(3) organizations must disclose the names and addresses of substantial contributors on their annual Form 990 information returns. Although § 501(c)(4) and certain other non-(c)(3) exempt organizations no longer will be required to disclose names and addresses of substantial contributors on their annual information returns once the regulations become final, such organizations nevertheless are required to keep records (which can be requested by the IRS) containing such information. Note: Code § 527 political organizations must continue to report the names and addresses of substantial contributors.

B. Charitable Giving

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. A nonprofit corporation is treated the same as a for-profit corporation for purposes of determining the interest rate on overpayments of tax. Maimonides Medical Center v. United States, 809 F.3d 85 (2d Cir. 12/18/15). In an opinion by Judge Lynch, the Second Circuit held that the lower interest rate that under § 6621(a)(1) applies to a refund for an overpayment of taxes due to a corporation applies to not-for-profit corporations as well as to for-profit corporations.

a. The Sixth Circuit agrees. United States v. Detroit Medical Center, 833 F.3d 671 (6th Cir. 8/12/16). The IRS refunded FICA taxes paid by the plaintiff, a not-for-profit corporation, for periods prior to 4/1/05 following the IRS's ruling that medical residents were eligible for the student exemption from FICA taxes. The IRS paid interest on the employer portion of the FICA taxes at the statutory rate provided by § 6621(a)(1) for corporations (the federal short-term rate plus 2 percentage points, reduced to 0.5 percentage points to the extent the overpayments exceed $10,000). The plaintiff asserted that, because it is a nonprofit corporation, it should not be treated as a corporation for this purpose. Instead, it asserted, it was entitled to interest at the higher statutory rate provided for non-corporate taxpayers (the federal short-term rate plus 3 percentage points). According to the plaintiff, it was entitled to additional interest of approximately $9.1 million. In an opinion by Judge Sutton, the Sixth Circuit held that nonprofit corporations are "corporations" for purposes of determining the rate of interest on overpayments. Accordingly, the court affirmed the District Court's grant of the government's motion for summary judgment.

b. The Seventh Circuit jumps on the bandwagon. Medical College of Wisconsin Affiliate Hospitals, Inc. v. United States, 854 F.3d 930 (7th Cir. 4/25/17). In a case raising the same issue, the United States Court of Appeals for the Seventh Circuit, in an opinion by Judge Easterbrook, concluded that a nonprofit corporation is entitled to interest on a tax overpayment at the statutory rate provided by § 6621(a)(1) for corporations.

c. The Tenth Circuit jumps on the (now overloaded?) bandwagon. Wichita Center for Graduate Medical Education, Inc. v. United States, 917 F.3d 1221 (10th Cir. 3/7/19). In yet another case raising the same issue, the United States Court of Appeals for the Tenth Circuit, in an opinion by Judge Tymkovich, agreed that a nonprofit corporation is nonetheless a "corporation" for purposes of the lower overpayment rate of interest set forth in § 6621(a)(1).

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

F. Liens and Collections

G. Innocent Spouse

H. Miscellaneous

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. Caught between a rock and a hard place: "the boss told me to do it" defense doesn't work to avoid liability for trust fund taxes, even when "the boss" is another federal government agency! Myers v. United States, 923 F.3d 1050 (11th Cir. 7/24/19). The taxpayer in this case was the CFO and co-President of two companies that failed to pay over to the IRS withheld employment taxes. At the time the two companies failed to pay over employment taxes, they were owned by a limited partnership parent company (a Small Business Investment Company or "SBIC") that was held under receivership by the Small Business Administration ("SBA"). The taxpayer maintained that he should not be held liable under § 6672(a) for the companies' failure to pay over employment taxes because an agent of the SBA told him to "prioritize other vendors over the trust fund taxes," which he did. After the taxpayer was assessed trust fund tax penalties by the IRS under § 6672(a), the taxpayer paid a portion of the assessment and sued for a refund in U.S. District Court for the Northern District of Georgia. The District Court granted summary judgment in favor of the government. On appeal to the Eleventh Circuit, the taxpayer argued that, although the "boss told me to do it" defense has been rejected in a number of decided cases involving private companies, the taxpayer's situation should be treated differently. Here, the taxpayer contended, the "boss" was another federal government agency. Therefore, according to the taxpayer, he was caught between a rock and

hard place: either ignore the SBA or ignore the IRS, both of which are federal government agencies. Nevertheless, the Eleventh Circuit, in a per curiam opinion by Judges Tjoflat, Jordan, and Schlesinger (the latter a District Judge sitting by designation) affirmed the District Court and held against the taxpayer, stating that § 6672(a) applies with "equal force when a government agency receiver tells a taxpayer not to pay trust fund taxes."

In a concurring opinion, Judge Jordan agreed with the result, but stated that the decision should be based on narrower grounds. As justification for his concern over the breadth of the court's holding, Judge Jordan cited *McCarty v. United States*, 437 F.2d 961 (Ct. Cl. 1971), where a taxpayer avoided responsible person liability under the predecessor of § 6672(a) in circumstances where the U.S. Navy had taken control of a company. Judge Jordan explained that in his view the taxpayer's real argument was that the IRS should be estopped from collecting trust fund taxes under § 6672(a) because the taxpayer was acting at the direction of another federal government agency. Judge Jordan further explained, though, that an estoppel argument by the taxpayer must be based upon the premise that the taxpayer's decision was objectively reasonable under the facts. Here, Judge Jordan wrote, a federal statute, 28 U.S.C. § 960, provides that "[a]ny officers and agents conducting any business under authority of a United States court shall be subject to all Federal . . . taxes applicable to such business to the same extent as if it were conducted by an individual or corporation." Given this express statutory directive, Judge Jordan concluded that the taxpayer could not have reasonably relied upon the "do-not-pay instructions" of the SBA receiver and the IRS thus should not be estopped from collecting trust fund taxes from the taxpayer under § 6672(a).

B. Self-employment Taxes

C. Excise Taxes

XII. TAX LEGISLATION

A. Enacted

1. Congress has enacted the Taxpayer First Act. The Taxpayer First Act, Pub. L. No. 116-25, was signed by the President on July 1, 2019. This legislation codifies and renames the IRS appeals function as the IRS Independent Office of Appeals, requires the IRS to develop a comprehensive customer service strategy, requires the Treasury Department to develop a comprehensive written plan to reorganize the IRS, and makes several significant changes to procedural tax rules.

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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Tax Law in a Day ● State Bar of Texas Tax Section
February 7, 2020

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This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted – unless one of us decides to go nuts and spend several pages writing one up. This is the reason that the outline is getting to be as long as it is. Amendments to the Internal Revenue Code are discussed to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected items previously covered in the outline, or (4) they provide an opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to us, at least) – income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services.

The year 2019 yielded many significant federal income tax developments. The Treasury Department and the Service continued to issue important administrative guidance pursuant to the legislation Congress enacted in late 2017, "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Pub. L. No. 115-97, and colloquially known as the "2017 Tax Cuts and Jobs Act." Yet 2019 saw its own tax legislation. The Taxpayer First Act, Pub. L. No. 116-25, enacted on July 1, 2019, directs certain organizational changes to the Service and makes several significant changes to procedural tax rules. The Further Consolidated Appropriations Act, 2020, Pub. L. No. 116-94, enacted on December 20, 2019, repealed the taxes commonly known as the medical device tax and the Cadillac tax, modified the rules for contributions to and distributions from certain retirement plans, temporarily extended several expired or expiring provisions, and provided tax relief to those in areas affected by certain natural disasters. This outline discusses the major administrative guidance issued in 2019, summarizes the 2019 legislative changes that, in our judgment, are the most important, and examines significant judicial decisions rendered in 2019.

I. ACCOUNTING

A. Accounting Methods

1. A genuine issue of material fact existed as to whether a C corporation (that eventually changed to an S corporation) adopted the deposit, in lieu of the deferral, method of accounting. Thrasys, Inc. v. Commissioner, 116 T.C.M. (CCH) 531, 2018 T.C.M. (RIA) ¶ 2018-199 (12/4/18). This case concerned whether the taxpayer, Thrasys, Inc., could, in its 2008 tax year, properly account for a $15 million payment received from its customer, Siemens, under the deferral method allowed by Rev. Proc. 2004-34. The Tax Court (Judge Lauber) dismissed the IRS's motion for summary judgment and concluded that genuine issues of material fact existed as to whether the taxpayer had adopted the "deposit" method of accounting in 2008. The IRS argued in its motion for summary judgment that the taxpayer could not switch from the "deposit" method of accounting—which the IRS argued the taxpayer had adopted for this type of payment through its accounting treatment—to the deferral method because it never received the IRS's consent to make that switch. Section 446(a) provides that "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Under Reg. § 1.446-1(e)(1), "[a] taxpayer filing his first return may adopt any permissible method of accounting

in computing taxable income for the taxable year covered by such return." Section 446(e) provides that "a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary." Moreover, according to the court, under § 446(a) and (e), "an accounting treatment constitutes a 'method of accounting' if the taxpayer 'regularly computes his income' using it." The court denied the IRS's motion for summary judgment, first, because the taxpayer treated only one customer payment (the 2008 $15 million payment from Siemens) as a deposit for book or federal income tax purposes (and then shifted the $15 million to the deferred revenue category on its Form 1120S in 2009). Therefore, "[a] question of material fact exists as to whether [taxpayer's] 'deposit' treatment displayed the consistency required to constitute a method of accounting on the basis of which Thrasys 'regularly compute[d]' its income." And, second, the Tax Court noted that a change in the taxpayer's "method of accounting does not include 'a change in treatment resulting from a change in underlying facts'" under Reg. § 1.446-1(e)(2)(ii)(b). Thrasys (and its auditor) "may reasonably have believed that treating the $15 million payment as a deposit was a required 'change in treatment resulting from a change in underlying facts'" because "Thrasys treated the $15 million payment differently from [other] customer payments received during 2005 to 2007," which were treated as advance payments and unearned, deferred revenue on its financial statements. The $15 million treatment as a deposit was based on the adjustments an independent auditor had made to taxpayer's 2008 financial statements (i.e., potentially a change in treatment due to a change in underlying facts). Therefore, the Tax Court found that genuine issues of material fact existed regarding whether Thrasys in 2008 actually "adopted the 'deposit' method as a method of accounting for customer payments," and accordingly, the Tax Court denied the IRS's motion for summary judgment.

2. Many small businesses will not qualify for several simplifying provisions enacted in the 2017 Tax Cuts and Jobs Act, such as the use of the cash method of accounting, because they meet the definition of a "tax shelter." In a letter to the IRS dated February 13, 2019, the American Institute of Certified Public Accountants has brought to the attention of the IRS the concern of many small businesses that, absent relief, they are ineligible for certain simplifying provisions enacted as part of the 2017 Tax Cuts and Jobs Act (TCJA) because the businesses meet the definition of a "tax shelter." 2019 TNT 31-16 (2/13/19). The letter requests appropriate relief.

Certain simplifying provisions enacted by the TCJA are available to businesses with average annual gross receipts not exceeding $25 million. The TJCA enacted several simplifying provisions that are available to a business if the business's average annual gross receipts, measured over the three prior years, do not exceed $25 million. These include the following: **(1)** the ability of C corporations or partnerships with a C corporation as a partner to use the cash method of accounting (§ 448(b)(3)), **(2)** the ability to use a method of accounting for inventories that either treats inventories as non-incidental materials and supplies or conforms to the taxpayer's financial accounting treatment of inventories (§ 471(c)(1)), **(3)** the ability to be excluded from applying the uniform capitalization rules of § 263A (§ 263A(i)), **(4)** the small construction contract exception that permits certain taxpayers not to use the percentage-of-completion method of accounting for certain construction contracts (§ 460(e)(1)(B)), and **(5)** the ability to be excluded from the § 163(j) limit on deducting business interest (§ 163(j)(3)).

The simplifying provisions enacted by the TCJA generally are not available to a "tax shelter." The simplifying provisions for small businesses listed above each state that they are not available to "a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)." Section 448(a)(3) provides that a "tax shelter" cannot compute taxable income under the cash receipts and disbursements method of accounting, and according to § 448(d)(3), the term "tax shelter" for this purpose is defined in § 461(i)(3). Section 461(i)(3) defines the term "tax shelter" as "(A) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale, (B) any syndicate (within the meaning of section 1256(e)(3)(B)), and (C) any tax shelter (as defined in section 6662(d)(2)(C)(ii))."

Many small businesses will meet the definition of a "syndicate" and therefore will be considered tax shelters. As discussed, the term "tax shelter" includes "any syndicate (within the meaning of section 1256(e)(3)(B))." The term "syndicate," according to § 1256(e)(3)(B), is "any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs." Many small businesses will meet this definition and will be precluded from using the simplifying provisions enacted by the TCJA. Businesses that fluctuate between having income and having losses could be in the position of having to change accounting methods.

The AICPA has requested relief. The AICPA has asked the IRS to exercise its authority, granted by § 1256(e)(3)(B), to treat an interest in an entity as not being held by a limited partner or a limited entrepreneur if certain conditions are met.

B. Inventories

C. Installment Method

D. Year of Inclusion or Deduction

1. Accrual-method taxpayers may have to recognize income sooner as a result of legislative changes. The 2017 Tax Cuts and Jobs Act, § 13221, amended Code § 451 to make two changes that affect the recognition of income and the treatment of advance payments by accrual method taxpayers. Both changes apply to taxable years beginning after 2017. Any change in method of accounting required by these amendments for taxable years beginning after 2017 is treated as initiated by the taxpayer and made with the consent of the IRS.

All events test linked to revenue recognition on certain financial statements. The legislation amended Code § 451 by redesignating § 451(b) through (i) as § 451(d) through (k) and adding a new § 451(b). New § 451(b) provides that, for accrual-method taxpayers, "the all events test with respect to any item of gross income (or portion thereof) shall not be treated as met any later than when such item (or portion thereof) is taken into account as revenue in" either (1) an applicable financial statement, or (2) another financial statement specified by the IRS. Thus, taxpayers subject to this rule must include an item in income for tax purposes upon the earlier of satisfaction of the all events test or recognition of the revenue in an applicable financial statement (or other specified financial statement). According to the Conference Report that accompanied the legislation, this means, for example, that any unbilled receivables for partially performed services must be recognized to the extent the amounts are taken into income for financial statement purposes. Income from mortgage servicing contracts is not subject to the new rule. The new rule also does not apply to a taxpayer that does not have either an applicable financial statement or another specified financial statement. An "*applicable financial statement*" is defined as (1) a financial statement that is certified as being prepared in accordance with generally accepted accounting principles that is (a) a 10-K or annual statement to shareholders required to be filed with the Securities and Exchange Commission, (b) an audited financial statement used for credit purposes, reporting to shareholders, partners, other proprietors, or beneficiaries, or for any other substantial nontax purpose, or (c) filed with any other federal agency for purposes other than federal tax purposes; (2) certain financial statements made on the basis of international financial reporting standards and filed with certain agencies of a foreign government; or (3) a financial statement filed with any other regulatory or governmental body specified by IRS.

Advance payments for goods or services. The legislation amended Code § 451 by redesignating § 451(b) through (i) as § 451(d) through (k) and adding a new § 451(c). This provision essentially codifies the deferral method of accounting for advance payments reflected in Rev. Proc. 2004-34, 2004-22 I.R.B. 991. New § 451(c) provides that an accrual-method taxpayer who receives an advance payment can either (1) include the payment in gross income in the year of receipt, or (2) elect to defer the category of advance payments to which such advance payment belongs. If a taxpayer makes the deferral election, then the taxpayer must include in gross income any portion of the advance payment required to be included by the applicable financial statement rule described above, and include the balance of the payment in gross income in the taxable year following the year of receipt. An advance payment is any payment: (1) the full inclusion of which in gross income for the taxable year of receipt

is a permissible method of accounting (determined without regard to this new rule), (2) any portion of which is included in revenue by the taxpayer for a subsequent taxable year in an applicable financial statement (as previously defined) or other financial statement specified by the IRS, and (3) which is for goods, services, or such other items as the IRS may identify. The term "advance payment" does *not* include several categories of items, including rent, insurance premiums, and payments with respect to financial instruments.

a. Guidance on accounting method changes relating to new § 451(b). Rev. Proc. 2018-60, 2018-51 I.R.B. 1045 (11/29/18). Rev. Proc. 2018-60 modifies Rev. Proc. 2018-31, 2018-22 I.R.B. 637, to provide procedures under § 446 and Reg. § 1.446-1(e) for obtaining automatic consent with respect to accounting method changes that comply with § 451(b), as amended by 2017 Tax Cuts and Jobs Act, § 13221. In addition, Rev. Proc. 2018-60 provides that for the first taxable year beginning after December 31, 2017, certain taxpayers are permitted to make a method change to comply with § 451(b) without filing a Form 3115, Application for Change in Accounting Method.

b. Proposed regulations issued on requirement of § 451(b)(1) that an accrual method taxpayer with an applicable financial statement treat the all events test as satisifed no later than the year in which it recognizes the revenue in an applicable financial statement. REG-104870-18, Taxable Year of Income Inclusion Under an Accrual Method of Accounting, 84 F.R. 47191 (9/9/19). The Treasury Department and the IRS have issued proposed regulations regarding the requirement of § 451(b)(1), as amended by the 2017 Tax Cuts and Jobs Act, that accrual method taxpayers with an applicable financial statement must treat the all events test with respect to an item of gross income (or portion thereof) as met no later than when the item (or portion thereof) is taken into account as revenue in either an applicable financial statement (AFS) or another financial statement specified by the IRS (AFS income inclusion rule). New Prop. Reg. § 1.451-3 clarifies how the AFS income inclusion rule applies to accrual method taxpayers with an AFS. Under Prop. Reg. § 1.451-3(d)(1), the AFS income inclusion rule applies only to taxpayers that have one or more AFS's covering the entire taxable year. In addition, the proposed regulations provide that the AFS income inclusion rule applies on a year-by-year basis and, therefore, an accrual method taxpayer with an AFS in one taxable year that does not have an AFS in another taxable year must apply the AFS income inclusion rule in the taxable year that it has an AFS, and does not apply the rule in the taxable year in which it does not have an AFS. The proposed regulations clarify that the AFS income inclusion rule does not change the applicability of any exclusion provision, or the treatment of non-recognition transactions, in the Code, regulations, or other published guidance. Generally, the proposed regulations (1) clarify how the AFS inclusion rule applies to multi-year contracts; (2) describe and clarify the definition of an AFS for a group of entities; (3) define the meaning of the term "revenue" in an AFS; (4) define a transaction price and clarify how that price is to be allocated to separate performance obligations in a contract with multiple obligations; and (5) describe and clarify rules for transactions involving certain debt instruments. The regulations are proposed to apply generally to taxable years beginning on or after the date final regulations are published in the Federal Register. Because the tax treatment of certain fees (such as certain credit card fees), referred to as "specified fees," is unclear, there is a one-year delayed effective date for Prop. Reg. § 1.451-3(i)(2), which applies to specified fees. Until final regulations are published, taxpayers can rely on the proposed regulations (other than the proposed regulations relating to specified fees) for taxable years beginning after December 31, 2017, provided that they: (1) apply all the applicable rules contained in the proposed regulations (other than those applicable to specified fees), and (2) consistently apply the proposed regulations to all items of income during the taxable year (other than specified fees). Taxpayers can similarly rely, subject to the same conditions, on the proposed regulations with respect to specified credit card fees for taxable years beginning after December 31, 2018.

c. Proposed regulations issued on advance payments for goods or services received by accrual method taxpayers with or without an applicable financial statement. REG-104554-18, Advance Payments for Goods, Services, and Other Items, 84 F.R. 47175 (9/9/19). The Treasury Department and the IRS have issued proposed regulations regarding accrual method taxpayers with or without an applicable financial statement (AFS) receiving advance payments for

goods or services. The proposed regulations generally provide that an accrual method taxpayer with an AFS includes an advance payment in gross income in the taxable year of receipt unless the taxpayer uses the deferral method in § 451(c)(1)(B) and Prop. Reg. § 1.451-8(c) (AFS deferral method). A taxpayer can use the AFS deferral method only if the taxpayer has an AFS, as defined in § 451(b)(1)(A)(i) or (ii). The term AFS is further defined in Prop. Reg. § 1.451-3(c)(1), issued on the same day as these proposed regiulations. Under the AFS deferral method, a taxpayer with an AFS that receives an advance payment must include: (i) the advance payment in income in the taxable year of receipt, to the extent that it is included in revenue in its AFS, and (ii) the remaining amount of the advance payment in income in the next taxable year. The AFS deferral method closely follows the deferral method of Rev. Proc. 2004-34 (as modified by Rev. Proc. 2011-14, 2011-4 I.R.B. 330, and as modified and clarified by Revenue Procedure 2011-18, 2011-5 I.R.B. 443, and Rev. Proc. 2013-29, 2013-33 I.R.B. 141). A similar deferral method is provided in § 1.451–8(d) for accrual method taxpayers thay do not have an AFS (non-AFS deferral method). Under the non-AFS deferral method, a taxpayer that receives an advanced payment must include (1) the advance payment in income in the taxable year of receipt to the extent that it is earned, and (2) the remaining amount of the advance payment in income in the next taxable year. In Prop. Reg. § 1.451–8(b)(1)(i), the proposed regulations clarify that the definition of advance payment under the AFS and non-AFS deferral methods is consistent with the definition of advance payment in Revenue Procedure 2004–34, which § 451(c) was meant to codify.The regulations are proposed to apply to taxable years beginning on or after the date the final regulations are published in the Federal Register. Until then, taxpayers can rely on the proposed regulations for taxable years beginning after December 31, 2017, provided that the taxpayer: (1) applies all the applicable rules contained in the proposed regulations, and (2) consistently applies the proposed regulations to all advance payments.

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. What are a professional sports team's player contracts really worth? Nothing, says the IRS. Rev. Proc. 2019-18, 2019-18 I.R.B. 1077 (4/11/19). In this revenue procedure, the IRS has provided a safe harbor for a professional sports team to treat certain personnel contracts (including those of players, managers, and coaches) and rights to draft players as having a zero value for purposes of determining gain or loss to be recognized for federal income tax purposes from the trade of a personnel contract or a draft pick. The IRS provided this safe harbor in recognition of the fact that the value of professional sports personnel contracts fluctuates and is highly subjective. The safe harbor is designed to "avoid highly subjective, complex, lengthy, and expensive disputes between professional sports teams and the IRS regarding the value of personnel contracts" and the resulting amount of gain or loss from their disposition. The revenue procedure applies to trades after April 10, 2019, but teams can choose to apply the revenue procedure to any open year. To be eligible for the safe harbor, a professional sports team's trade of personnel contracts and draft picks must meet four requirements: **(1)** all parties to the trade that are subject to federal income tax in the U.S. must treat the trade in a manner consistent with the revenue procedure; **(2)** each team that is a party to the trade must trade a personnel contract or a draft pick and no party to the trade may transfer property other than a personnel contract, draft pick, or cash; **(3)** no personnel contract or draft pick traded is an amortizable § 197 intangible; and **(4)** the financial statements of the teams that are parties to the trade do not reflect assets or liabilities resulting from the trade other than cash. If the safe harbor applies to a trade, then the following five principles govern the tax treatment of the trade:

1. *Gain or loss generally not recognized.* Except to the extent required by the fifth principle (below), a team making a trade within the safe harbor does not recognize gain or loss from the trade. (As described below, a team must recognize any gain or loss realized if it receives cash in the trade.)
2. *Only cash received is included in a team's amount realized.* A team that receives cash in a trade must include the cash in amount realized. Because personnel contracts and draft picks are

treated as having a value of zero, a team that receives only these assets has an amount realized of zero.

3. *A team's basis in personnel contracts and draft picks received includes only cash provided.* A team that provides cash in exchange for personnel contracts or draft picks has a basis in the assets acquired equal to the cash provided. A team that provides only personnel contracts or draft picks has a basis in the assets received of zero.

4. *Cash provided must be allocated equally to personnel contracts or draft picks received.* A team that provides cash and receives more than one personnel contract or draft pick must determine its basis in the assets acquired by allocating the cash equally among the assets acquired.

5. *A team determines its gain or loss recognized by comparing its amount realized with the unrecovered basis of any personnel contracts and draft picks provided.* A team making a trade within the safe harbor must recognize gain or loss to the extent its amount realized (as determined under the second principle) exceeds or falls below its unrecovered basis in the personnel contracts and draft picks it provides. The character of any gain or loss recognized is determined under the normal rules, e.g., a team's gain or loss might be a § 1231 gain or loss and any gain a team recognizes might be ordinary under § 1245.

The revenue procedure provides the following four examples:

Example 1—Trade with no cash.

1. In 2018, Team A trades Player Contract 1 to Team B for Player Contract 2. The teams apply the safe harbor in this revenue procedure.

2. Neither Team A nor Team B has an amount realized or gain on the trade because neither team received cash in the trade. Team A has a $0 basis in Player Contract 2, and Team B has a $0 basis in Player Contract 1.

Example 2—One team provides cash in the trade.

1. The facts are the same as in Example 1, except Team A trades Player Contract 1 and $10x to Team B for Player Contract 2.

2. Team A has no amount realized or gain on the trade because Team A did not receive cash in the trade. Team A has a $10x basis in Player Contract 2, the amount of cash Team A provided to Team B in the trade. Team A's $10x basis is recovered through depreciation under Reg. § 1.167(a)-3(a) over the life of Player Contract 2.

3. Team B has a $10x amount realized on the trade because Team B received $10x from Team A in the trade. Team B must recognize $10x of gain, the excess of Team B's $10x amount realized over its $0 basis in the Player Contract 2 it traded. Team B's $10x gain is subject to the rules of §§ 1231 and 1245. Team B has a $0 basis in Player Contract 1 because Team B provided no cash to Team A in the trade.

Example 3—No cash in the trade, one team has unrecovered basis.

1. In 2019, Team C signs Player 3 to a contract (Player Contract 3) for 5 years. Under the terms of Player Contract 3, Team C pays Player 3 a $25x signing bonus in 2019. In each of 2019 and 2020, Team C takes a depreciation deduction under Reg. § 167(a)-3(a) of $5x for the $25x it paid to Player 3. In 2021, Team C trades Player Contract 3 to Team D for Player Contract 4, and the teams apply the safe harbor in this revenue procedure.

2. Neither Team C nor Team D has an amount realized or gain on the trade because neither team received cash in the trade. Because neither team provided cash in the trade, each team has a $0 basis in the contract it received in the trade.

3. Team C may deduct in 2021 a $15x loss under §§ 165 and Reg. § 1.167(a)-8, the excess of its unrecovered basis in Player Contract 3 over its amount realized of $0. Team C's $15x loss is subject to the rules of § 1231.

Example 4—One team provides cash and one team has an unrecovered basis.

1. The facts are the same as in Example 3, except Team D trades Player Contract 4 and $20x to Team C for Player Contract 3.

2. Team C has a $20x amount realized on the trade because Team C received $20x from Team D in the trade. Team C must recognize $5x of gain, the excess of Team C's $20x amount realized over its $15x basis in the Player Contract 3 it traded. Team C's $5x gain is subject to the rules of §§ 1231 and 1245. Team C has a $0 basis in Player Contract 4 because Team C provided no cash to Team D in the trade.

3. Team D has no amount realized or gain on the trade because Team D did not receive cash in the trade. Team D has a $20x basis in Player Contract 3, the amount of cash Team D provided to Team C in the trade. Team D's $20x basis is recovered through depreciation under Reg. § 1.167(a)-3(a) over the life of Player Contract 3.

Example 5—Allocation of basis among multiple contracts.

1. In 2019, Team E trades Player Contract 5 and $30x to Team F for Player Contract 6, Player Contract 7,and Player Contract 8. The teams apply the safe harbor in this revenue procedure.

2. Team E has no amount realized or gain on the trade because Team E did not receive cash in the trade. Under section 4.02(3), Team E has a $30x basis in Player Contract 6, Player Contract 7, and Player Contract 8, collectively. Team E has a basis of $10x in Player Contract 6, $10x in Player Contract 7, and $10x in Player Contract 8 because Team E allocates the $30x cash provided to Team F in the trade by dividing the basis equally among the three player contracts received in the trade. Team E's $10x basis of each player contract is recovered through depreciation under Reg. § 1.167(a)-3(a) over the life of the respective player contract.

3. Team F has a $30x amount realized on the trade because Team F received $30x from Team E in the trade. Team F must recognize $30x of gain, the excess of Team F's $30x amount realized over its $0 basis in the Player Contract 5 it traded. Team F's $30x gain is subject to the rules of §§ 1231 and 1245. Team F has a $0 basis in Player Contract 5 because Team F provided no cash to Team E in the trade.

B. Deductible Expenses versus Capitalization

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

> Although WRP I deducted its property taxes, those taxes directly benefit the growing of the almond trees and are allocable to the produced property (the almond trees) that will produce income in the future. Allowing a current deduction of the property taxes would distort WRP I's actual income for the subject years and would otherwise allow WRP I to offset its unrelated income. This is precisely the mismatch of expenses and revenues that section 263A was enacted to prevent.

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

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

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

2. Up in Smoke: the deductions of this medical marijuana business were disallowed by § 280E and could not be capitalized under the uniform capitalization rules of § 263A. Patients Mutual Assistance Collective Corp. v. Commissioner, 151 T.C. No. 11 (11/29/18). The taxpayer, a subchapter C corporation engaged in the medical marijuana business in California, argued that its deductions for business expenses were not subject to disallowance under § 280E. Section 280E disallows any deduction or credit otherwise allowable if such amount is paid or incurred in connection with a trade or business "if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances …." In a lengthy opinion by Judge Holmes, the Tax Court rejected the taxpayer's argument that the words "consists of" in § 280E mean that the statute applies only to businesses that exclusively or solely engage in trafficking controlled substances and does not apply to businesses, like the taxpayer's, that also engage in other activities such as offering acupuncture services and group sessions for yoga and tai chi. Judge Holmes noted that the court had "cursorily rejected" a nearly identical argument in *Olive v. Commissioner*, 139 T.C. 19 (2012), *aff'd*, 792 F.3d 1146 (9th Cir. 2015), but given the importance of the issue to the industry, explained the court's reasoning at greater length. The court further held that the taxpayer had only one trade or business. Accordingly, § 280E applied to disallow the taxpayer's deductions. The court also considered whether the taxpayer was required to determine cost of goods sold under the rules of § 471 or, instead, under the rules of § 263A. Section 263A provides that both resellers as well as producers of property must include indirect costs in cost of goods sold and broadens the indirect costs that must be included. The court concluded that the rules of § 263A did not apply to the taxpayer because of the flush language of § 263A(a)(2), which provides:

> Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.

The court analyzed the regulations that interpret this provision and concluded that the statute's meaning is that "if something wasn't deductible before Congress enacted section 263A, taxpayers cannot use that section to capitalize it." The court rejected several arguments of the taxpayer to the contrary. Because the rules of § 263A did not apply, only the rules of § 471 did. (Unlike § 263A, § 471 was in place when Congress enacted § 280E.) The rules of § 471 distinguish between resellers and producers of property. Under Reg. § 1.471-3(b), resellers must use as their cost of goods sold the price

they pay for inventory plus any "transportation or other necessary charges incurred in acquiring possession of the goods." The court concluded that the taxpayer was a reseller and therefore, pursuant to the regulations under § 471, could not include indirect costs in determining cost of goods sold. Finally, the court rejected the taxpayer's argument that the government was barred by *res judicata* from pursuing the case because of the government's prior decision to abandon a civil forfeiture action against the taxpayer.

C. Reasonable Compensation

D. Miscellaneous Deductions

1. Wrongful death settlement costs for the cocaine overdose death of the CEO's girlfriend is not a deductible corporate business expense. Cavanaugh v. Commissioner, T.C. Memo. 2012-324 (11/26/12). James Cavanaugh, the CEO and sole shareholder of Jani-King International, took a holiday trip to the Cavanaugh's villa in St. Maarten with his 27-year old girlfriend, a bodyguard, and another female Jani-King employee. Unfortunately the girlfriend died from an overdose of cocaine. The girlfriend's mother sued the individuals and the corporation for wrongful death. The taxpayer's S corporation paid the full amount of the settlement, including a $250,000 reimbursement to Cavanaugh and claimed a business expense deduction. The Tax Court (Judge Holmes) began its opinion in this case as follows:

> Twenty-seven-year-old Colony Anne (Claire) Robinson left Texas in November 2002 for a Thanksgiving vacation in the Caribbean with her boyfriend, his bodyguard, and another employee of the company that he had spent decades building.
>
> She did not return home alive.
>
> The coroner's report showed a massive amount of illegal drugs in her body and concluded that they were the likely cause of her death. Her mother sued the boyfriend and his company for wrongful death. The parties settled. The company paid most of the $2.3 million settlement directly; the boyfriend contributed $250,000, which the company then reimbursed.

Siding with the IRS, Judge Holmes looked to the origin of the claim, which the court held to be applicable to the corporation's payment in settlement of the wrongful death claim. The court concluded that although the claim related to the conduct of the three corporate employees, the conduct was not related to the corporate business, i.e., its profit-seeking activities. The court also rejected the taxpayer's theory that the bodyguard supplied cocaine in the course of his employment as a bodyguard and enabler for the CEO. Further, the court rejected the taxpayer's argument that reimbursement of the taxpayer's contribution to the settlement was contractually required under a corporate indemnity agreement. In addition, the court found that the payment was not deductible under the theory that it was made to protect the corporation's business reputation because there was no evidence that underlay that theory.

- Judge Holmes distinguished and refused to follow *Kopp's Co. v. United States*, 636 F.2d 59 (4th Cir. 1980), in which the court upheld a corporation's deduction for a payment made to settle pending litigation against the corporation brought by an individual injured by the CEO's son who, while home on military leave and making "personal and permissive use of" a corporate-owned car, had an accident that severely injured the individual.

a. The corporation's deductions are vaporized like freebase on appeal. Cavanaugh v. Commissioner, 766 Fed. Appx. 98 (5th Cir. 3/29/19), *aff'g* T.C. Memo. 2012-324 (11/26/12). In a per curiam opinion, the U.S. Court of Appeals for the Fifth Circuit affirmed the Tax Court's decision. The court agreed with the Tax Court that, under *United States v. Gilmore*, 372 U.S. 39 (1963), the deductibility of the corporation's litigation expenses is determined by the origin and character of the claim against it, and not by the claim's potential consequences. The court rejected the taxpayer's argument that the *Gilmore* analysis does not apply when the corporation itself is named as a defendant in the litigation that is settled. Decisions holding otherwise, the court stated, such as *Kopp's Co. v. United States*, 636 F.2d 59 (4th Cir. 1980), "directly conflict with *Gilmore*, which is binding on

this court." In this case, the court reasoned, although the board of directors of Jani-King International approved the settlement on the advice of counsel, the claim arose from the provision of cocaine by employees of Jani-King, a non-business activity, and not from their employment by Jani-King. Accordingly, the court held, the Tax Court properly disallowed the corporation's deduction of the settlement payment. The court also held that the Tax Court properly had disallowed the corporation's deduction of its reimbursement of James Cavanaugh for the $250,000 he had contributed. According to the court, Cavanaugh had waived the argument that the reimbursement was required by the corporation's by-laws, and the payment was a nondeductible voluntary payment by the corporation of another's legal expenses.

2. Rats! We knew that we should have been architects or engineers instead of tax advisors. The 2017 Tax Cuts and Jobs Act, § 11011, added § 199A, thereby creating an unprecedented, new deduction for trade or business (and certain other) income earned by sole proprietors, partners of partnerships (including members of LLCs taxed as partnerships or as sole proprietorships), and shareholders of S corporations. The Consolidated Appropriations Act, 2018, Pub. L. No. 115-141, Division T, § 101 ("CAA 2018"), signed by the President on March 23, 2018, amended § 199A principally to address issues related to agricultural or 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).

3. Tax Court blows out the flame on California medical marijuana dispensary's deductions. A related subchapter S corporation's deductions also were disallowed. Alternative Health Care Advocates v. Commissioner, 151 T.C. No. 13 (12/20/18). A California medical marijuana dispensary claimed deductions under § 162 for business expenses. The dispensary was organized as a C corporation (Alternative) that operated the dispensary and a subchapter S corporation (Wellness) that handled daily operations for Alternative, including paying employee wages and salaries. The Tax Court (Judge Pugh) agreed with the IRS that the deductions claimed by both Alternative and Wellness were disallowed by § 280E. Section 280E disallows any deduction or credit otherwise allowable if such amount is paid or incurred in connection with a trade or business "if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances …." Judge Pugh concluded that Alternative had only one trade or business because its nonmarijuana activities "were only ancillary" to its primary activity of operating a marijuana dispensary. Therefore, Alternative could not allocate its expenses between a trafficking business and a non-trafficking business and § 280E operated to disallow all of Alternative's claimed deductions. With respect to the subchapter S corporation, Wellness, the court concluded that "Wellness employees were directly involved in the provision of medical marijuana to the patient members of Alternative's dispensary." Further, according to the court, Wellness employees were engaged in the purchase and sale of marijuana on behalf of Alternative and this activity was the primary business of Wellness. Accordingly, although Wellness never took title to marijuana, the court held that Wellness was engaged in trafficking in controlled substances. Therefore, § 280E disallowed deductions claimed by Wellness, which resulted in additional income flowing to the shareholders of Wellness. The court also held that Alternative could not add direct and indirect costs of inventory to its cost of goods sold under § 263A because, by virtue of § 263A(a)(2), "[s]ection 263A puts into COGS only expenses otherwise deductible." (The court previously had reached this conclusion and applied it to a medical marijuana business in *Patients Mutual Assistance Collective Corp. v. Commissioner*, 151 T.C. No. 11 (11/29/18).) The court held that Alternative was not a producer, but rather a reseller of marijuana products, and therefore could not increase its cost of goods sold § 471 beyond what the IRS had allowed for the taxable years at issue. Finally, the Tax Court held that Alternative was liable for the § 6662(a) accuracy-related penalty for the taxable years at issue due to substantial understatements of income tax for those years.

4. Tax Court holds that, although struggling business owner never used two properties in his trade or business, mortgage interest paid with respect to the properties was not subject to limitations on investment interest and was deductible on Schedule C. Pugh v. Commissioner, T.C. Summ. Op. 2019-2 (2/28/19). The taxpayer, who holds a Bachelor of Science degree in electrical engineering, operated a sole proprietorship, Pi Integrated Systems (Pi), which was engaged in software development. Pi operated from an office in the taxpayer's home. He borrowed money to purchase two vacant lots in 2005 and 2006 and paid interest on the loans. He purchased two steel buildings, disassembled them, and stored some of the components on one of the properties. He planned to reassemble the buildings on the vacant lots, as reflected in a site plan prepared by an architect in 2007, and to use the buildings as the headquarters of Pi. Pi experienced the loss of a major customer, a loss of revenue, and a loss of employees, and the plans to reassemble the buildings never took place. As of the date of trial in 2017, the lots remained vacant and some of the building components had been sold for scrap metal. On his federal income tax returns for 2010 and 2011, which were submitted to the IRS long after they were due and apparently never processed by the IRS, the taxpayer claimed several deductions on Schedule C, including a deduction for the mortgage interest paid on the loans used to finance the acquisition of the vacant lots and a deduction for legal fees. The IRS allowed all but a small amount of the legal fees as deductions but disallowed the deductions for mortgage interest. The IRS argued that, because the properties were never actually used in the

taxpayer's trade or business, the interest was not deductible as it was either "personal interest" within the meaning of § 163(h) or was "investment interest" within the meaning of § 163(d) and therefore deductible only to the extent of net investment income, which the taxpayer did not have. The Tax Court (Judge Carluzzo) first concluded that the interest paid by the taxpayer was not "investment interest," which is defined in § 163(d)(3)(A) as deductible interest paid or accrued on indebtedness properly allocable to property held for investment. The term "property held for investment" is defined in § 163(d)(5)(A) as property that produces income of a type described in § 469(e)(1), which generally describes passive investment income such as interest, dividends, rents, and royalties. According to the court, the land the taxpayer purchased was not property held for investment and therefore the interest he paid on the loans used to finance the purchase could not be investment interest. The Tax Court also held that the interest was not nondeductible "personal interest" as defined in § 163(h)(2) because it fit into one of the categories excluded from the definition of personal interest. One of those categories, set forth in § 163(h)(2)(A), is interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee). The Tax Court concluded that "the properties were not actually used in petitioner's trade or business during the years in issue. Nevertheless, we are satisfied that the properties were certainly 'allocable' to that business." The Tax Court disallowed the taxpayer's deduction of the small amount of remaining legal fees that the IRS had not allowed. "Because [the taxpayer] has failed to establish the nature of the legal services involved, how those services relate to his trade or business, or the amounts actually paid or incurred for those services, he is not entitled to a deduction for legal fees in excess of the amount already allowed by [the IRS] for each year in issue."

5. A retroactive incentive to make commercial buildings energy efficient. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title I, § 130 of the 2020 Further Consolidated Appropriations Act, retroactively extended the § 179D deduction for the cost of energy efficient commercial building property. Generally, these are improvements designed to reduce energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation, and hot water systems of a commercial building by 50 percent or more in comparison to certain standards. The lifetime limit on deductions under § 179D is $1.80 per square foot. This provision had expired for property placed in service after December 31, 2017. As extended, the deduction is available for property placed in service before January 1, 2021.

E. Depreciation & Amortization

1. Certain depreciation and amortization provisions of the 2017 Tax Cuts and Jobs Act:

a. Increased limits and expansion of eligible property under § 179.

Increased § 179 Limits. The 2017 Tax Cuts and Jobs Act, § 13101, increased the maximum amount a taxpayer can deduct under § 179 to $1 million (increased from $520,000). This limit is reduced dollar-for-dollar to the extent the taxpayer puts an amount of § 179 property in service that exceeds a specified threshold. The legislation increased this threshold to $2.5 million (increased from $2,070,000). These changes apply to property placed in service in taxable years beginning after 2017. The legislation did not change the limit on a taxpayer's § 179 deduction for a sport utility vehicle, which remains at $25,000. The basic limit of $1 million, the phase-out threshold of $2.5 million, and the sport utility vehicle limitation of $25,000 all will be adjusted for inflation for taxable years beginning after 2018.

Revised and expanded definition of qualified real property. The 2017 Tax Cuts and Jobs Act, § 13101, also simplified and expanded the definition of "qualified real property," the cost of which can be deducted under § 179 (subject to the applicable limits just discussed). Prior to amendment by the 2017 Tax Cuts and Jobs Act, § 179(f) defined qualified real property as including "qualified leasehold improvement property," "qualified restaurant property," and "qualified retail improvement property." The legislation revised the definition of qualified real property by replacing these three specific categories with a single category, "qualified improvement property" as defined in § 168(e)(6). Section

168(e)(6) defines qualified improvement property (subject to certain exceptions) as "any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service." In addition, the legislation expands the category of qualified real property by defining it to include the following improvements to nonresidential real property placed in service after the date the property was first placed in service: (1) roofs, (2) heating, ventilation, and air-conditioning property, (3) fire protection and alarm systems, and (4) security systems. These changes apply to property placed in service in taxable years beginning after 2017.

Section 179 property expanded to include certain personal property used to furnish lodging. The 2017 Tax Cuts and Jobs Act, § 13101, also amended Code § 179(d)(1). The effect of this amendment is to include within the definition of § 179 property certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging (such as beds or other furniture, refrigerators, ranges, and other equipment).

Guidance on the procedure for electing to treat qualified real property as § 179 property. In Rev. Proc. 2019-8, 2019-3 I.R.B. 347 (12/21/18), the IRS provided the procedure by which taxpayers can elect to deduct the cost of qualified real property under § 179(a). According to the notice, for qualified real property placed in service in taxable years beginning after 2017, taxpayers make the election "by filing an original or amended Federal tax return for that taxable year in accordance with procedures similar to those in § 1.179-5(c)(2) and section 3.02 of Rev. Proc. 2017–33." Taxpayers that have filed an original return can elect to increase the portion of the cost of qualified real property deducted under § 179(a) by filing an amended return and will not be treated as having revoked a prior election under § 179 for that year.

b. Goodbye, basis; hello 100 percent § 168(k) bonus first-year depreciation!

100 percent bonus depreciation for certain property. The 2017 Tax Cuts and Jobs Act, § 13201, amended Code § 168(k)(1) and 168(k)(6) to permit taxpayers to deduct 100 percent of the cost of qualified property for the year in which the property is placed in service. This change applies to property *acquired and placed in service* after September 27, 2017, and before 2023. The percentage of the property's adjusted basis that can be deducted is reduced from 100 percent to 80 percent in 2023, 60 percent in 2024, 40 percent in 2025, and 20 percent in 2026. (These periods are extended by one year for certain aircraft and certain property with longer production periods). Property *acquired on or before September 27, 2017* and placed in service after that date is eligible for bonus depreciation of 50 percent if placed in service before 2018, 40 percent if placed in service in 2018, 30 percent if placed in service in 2019, and is ineligible for bonus depreciation if placed in service after 2019.

Used property eligible for bonus depreciation. The legislation also amended Code § 168(k)(2)(A) and (E) to make used property eligible for bonus depreciation under § 168(k). Prior to this change, property was eligible for bonus depreciation only if the original use of the property commenced with the taxpayer. This rule applies to property *acquired and placed in service* after September 27, 2017. Note, however, that used property is eligible for bonus depreciation only if it is acquired "by purchase" as defined in § 179(d)(2). This means that used property is *not* eligible for bonus depreciation if the property (1) is acquired from certain related parties (within the meaning of §§ 267 or 707(b)), (2) is acquired by one component member of a controlled group from another component member of the same controlled group, (3) is property the basis of which is determined by reference to the basis of the same property in the hands of the person from whom it was acquired (such as a gift), or (4) is determined under § 1014 (relating to property acquired from a decedent). In addition, property acquired in a like-kind exchange is not eligible for bonus depreciation.

Qualified property. The definition of "qualified property" eligible for bonus depreciation continues to include certain trees, vines, and plants that bear fruits or nuts (deductible at a 100 percent level for items planted or grafted after September 27, 2017, and before 2023, and at reduced percentages for items planted or grafted after 2022 and before 2027). The definition also includes a qualified film or television production. Excluded from the definition is any property used in a trade or

business that has had floor plan financing indebtedness (unless the business is exempted from the § 163(j) interest limitation because its average annual gross receipts over a three-year period do not exceed $25 million).

Section 280F $8,000 increase in first-year depreciation. For passenger automobiles that qualify, § 168(k)(2)(F) increases by $8,000 in the first year the § 280F limitation on the amount of depreciation deductions allowed. The legislation continues this $8,000 increase for passenger automobiles *acquired and placed in service* after 2017 and before 2023. For passenger automobiles acquired *on or before* September 27, 2017, and placed in service after that date, the previously scheduled phase-down of the $8,000 increase applies as follows: $6,400 if placed in service in 2018, $4,800 if placed in service in 2019, and $0 after 2019.

c. Changes to the 280F depreciation limits on passenger automobiles and removal of computer and peripheral equipment from the definition of listed property. The 2017 Tax Cuts and Jobs Act, § 13202, amended Code § 280F(a)(1)(A) to increase the maximum amount of allowable depreciation for passenger automobiles and for which bonus depreciation under § 168(k) is not claimed. The maximum amount of allowable depreciation is $10,000 for the year in which the vehicle is placed in service, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years in the recovery period. The legislation also amended § 280F(d)(4) to remove computer or peripheral equipment from the definition of listed property. Both changes apply to property placed in service after 2017 in taxable years ending after 2017.

d. Changes to the depreciation of certain property used in a farming business.

Modifications to the depreciation of farm machinery and equipment. The 2017 Tax Cuts and Jobs Act, § 13203, made two changes with respect to the depreciation of any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) that is used in a farming business. (For this purpose, the term "farming business" is defined in Code § 263A(e)(4).) The legislation amended Code § 168(b)(2) and (e)(3)(B) to repeal the required use of the 150 percent declining balance method and to reduce the recovery period from 7 years to 5 years. Accordingly, such machinery and equipment should be depreciable over 5 years using the double-declining balance method and the half-year convention. This change applies to property placed in service after 2017 in taxable years ending after 2017.

Mandatory use of ADS for farming businesses that elect out of the new interest limitation. The 2017 Tax Cuts and Jobs Act, § 13205, amended Code § 168 to add new § 168(g)(1)(G), which requires a farming business that elects out of the newly-enacted interest limitation of § 163(j) to use the alternative depreciation system for any property with a recovery period of 10 years or more. This change applies to taxable years beginning after 2017. Note: aside from longer recovery periods, the requirement to use the alternative depreciation system for property with a recovery period of 10 years or more would seem to have the effect of making such property ineligible for bonus depreciation under § 168(k) even if it normally would be eligible for bonus depreciation.

- For guidance on the application of the alternative depreciation system in this situation, see Rev. Proc. 2019-8, 2019-3 I.R.B. 347 (12/21/18).

e. Revised definitions and minor adjustments to recovery periods for real property. With respect to real property, the 2017 Tax Cuts and Jobs Act, § 13204, amended Code § 168 to simplify certain definitions and make minor adjustments for purposes of the alternative depreciation system.

Three categories consolidated into one. The legislation replaced the categories of "qualified leasehold improvement property," "qualified restaurant property," and "qualified retail improvement property" with a single category, "qualified improvement property." Code § 168(e)(6) defines qualified improvement property (subject to certain exceptions) as "any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date

such building was first placed in service." Qualified improvement property is depreciable over 15 years using the straight-line method and is subject to the half-year convention. This change applies to property placed in service after 2017. **Note:** the Conference Agreement indicates that the normal recovery period for qualified improvement property is 15 years, but § 168 as amended does not reflect this change. This should be addressed in technical corrections.

Residential rental property has a 30-year ADS recovery period. The legislation reduced the recovery period for residential rental property for purposes of the alternative depreciation system from 40 years to 30 years. The general recovery period for such property remains at 27.5 years. This change applies to property placed in service after 2017. An optional depreciation table for residential rental property with a 30-year ADS recovery period appears in Rev. Proc. 2019-8, 2019-3 I.R.B. 347 (12/21/18).

Mandatory use of ADS for real property trades or businesses electing out of the new interest limitation. The legislation amended Code § 168 to add new § 168(g)(1)(F) and (g)(8), which require a real property trade or business that elects out of the newly-enacted interest limitation of § 163(j) to use the alternative depreciation system for nonresidential real property, residential rental property, and qualified improvement property. This change applies to taxable years beginning after 2017. Note: aside from longer recovery periods, the requirement to use the alternative depreciation system for qualified improvement property would seem to have the effect of making qualified improvement property ineligible for bonus depreciation under § 168(k).

- For guidance on the application of the alternative depreciation system in this situation, see Rev. Proc. 2019-8, 2019-3 I.R.B. 347 (12/21/18).

f. The IRS has issued final regulations that provide guidance on § 168(k) first-year depreciation. T.D. 9874, Additional First Year Depreciation Deduction, 84 F.R. 50108 (9/24/19). The Treasury Department and the IRS have finalized, with some changes, proposed regulations issued under § 168(k) in 2018. See REG-104397-18, Additional First Year Depreciation Deduction, 83 F.R. 39292 (8/8/18). These regulations provide guidance regarding the additional first-year depreciation deduction (so-called "bonus depreciation") under § 168(k) as amended by the 2017 Tax Cuts and Jobs Act. They affect taxpayers who deduct depreciation for qualified property acquired and placed in service after September 27, 2017. Generally, the regulations provide detailed guidance on the requirements that must be met, including specific requirements that apply to used property, for depreciable property to qualify for the additional first-year depreciation deduction provided by § 168(k). The preamble to the final regulations notes that some comments submitted on the proposed regulations had requested that the final regulations provide that "qualified improvement property" (discussed above) placed in service after 2017 is eligible for additional first-year depreciation under § 168(k). The Treasury Department and the IRS declined to adopt this suggested change because the relevant statutory provisions do not permit it. Although the Conference Agreement that accompanied the 2017 Tax Cuts and Jobs Act states that qualified improvement property is depreciable over 15 years, § 168 as amended by the 2017 Tax Cuts and Jobs Act does not reflect this change. Accordingly, the recovery period for qualified improvement property is 39 years. Because property that qualifies for the additional first-year depreciation deduction generally must have a revocery period of 20 years or less, qualified improvement property placed in servce after 2017 is not eligible for bonus depreciation. The final regulations are effective on September 24, 2019, but taxpayers can choose to apply them in their entirely to qualified property acquired and placed in service (or planted or grafted) after September 27, 2017, during taxable years ending on or after September 28, 2017. For qualified property acquired and placed in service (or planted or grafted) after September 27, 2017, during taxable years ending after that date and before September 24, 2019, taxpayers can rely on the proposed regulations.

2. The IRS comes to the rescue to allow depreciation of passenger automobiles that qualify for 100 percent bonus depreciation under § 168(k). Rev. Proc. 2019-13, 2019-9 I.R.B. (2/13/19). Under § 280F(a)(1)(B)(i), the "unrecovered basis" of a passenger automobile that is subject to the § 280F limits on depreciation is treated as an expense for the first taxable year after the automobile's recovery period. For passenger automobiles eligible for 100 percent first-year

depreciation under § 168(k), the amount by which the cost of the vehicle (before any § 179 deduction) exceeds the first year § 280F limitation is the "unrecovered basis" for purposes of § 280F(a)(1)(B)(i). In other words, if a taxpayer does not elect out of 100 percent first-year bonus depreciation, then the taxpayer can deduct in the year the vehicle is placed in service the maximum amount allowed under § 280F(a)(1)(A) and then cannot deduct any additional portion of the vehicle's cost until after the recovery period has passed, at which point the taxpayer can deduct the unrecovered cost as an expense, subject to the annual $5,670 limitation specified in § 280F(a)(1)(B)(ii). The revenue procedure gives the following example:

> For example, if a calendar-year taxpayer places in service in December 2018 a passenger automobile that costs $50,000 and is qualified property for which the 100-percent additional first-year depreciation deduction is allowable, the 100-percent additional first-year depreciation deduction and any § 179 deduction for this property is limited to $18,000 under § 280F(a)(1)(A)(i) (see Table 2 of Rev. Proc. 2018-25) and the excess amount of $32,000 is recovered by the taxpayer beginning in 2024, subject to the annual limitation of $5,760 under § 280F(a)(1)(B)(ii).

To avoid this result, the revenue procedure provides a safe harbor method of accounting for determining depreciation deductions for passenger automobiles that qualify for 100 percent bonus depreciation under § 168(k). The safe harbor method permits taxpayers to deduct a portion of the vehicle's cost in each year of the recovery period. The IRS issued a similar ruling, Rev. Proc. 2011-26, 2011-16 I.R.B. 664, in response to Congress's enactment of 100 percent bonus depreciation for 2010.

Bonus Depreciation Under § 168(k) as Amended by the 2017 Tax Cuts and Jobs Act. The 2017 Tax Cuts and Jobs Act, § 13201, amended Code § 168(k)(1) and 168(k)(6) to permit taxpayers to deduct 100 percent of the cost of qualified property for the year in which the property is placed in service. This change applies to property *acquired and placed in service* after September 27, 2017, and before 2023. The percentage of the property's adjusted basis that can be deducted is reduced from 100 percent to 80 percent in 2023, 60 percent in 2024, 40 percent in 2025, and 20 percent in 2026. (These periods are extended by one year for certain aircraft and certain property with longer production periods). Property *acquired before September 28, 2017* and placed in service on or after that date is eligible for bonus depreciation of 50 percent if placed in service before 2018, 40 percent if placed in service in 2018, 30 percent if placed in service in 2019, and is ineligible for bonus depreciation if placed in service after 2019. The legislation also amended Code § 168(k)(2)(A) and (E) to make used property eligible for bonus depreciation under § 168(k).

Section 280F $8,000 increase in first-year depreciation. For passenger automobiles that qualify, § 168(k)(2)(F) increases by $8,000 in the first year the § 280F limitation on the amount of depreciation deductions allowed. The 2017 Tax Cuts and Jobs Act continues this $8,000 increase for passenger automobiles *acquired and placed in service after* September 27, 2017, and before 2023. (For passenger automobiles acquired *before* September 28, 2017, and placed in service on or after that date, the previously scheduled phase-down of the $8,000 increase applies as follows: $6,400 if placed in service in 2018, $4,800 if placed in service in 2019, and $0 after 2019.) According to Rev. Proc. 2018-25, 2018-18 I.R.B. 543 (4/17/18), the § 280F depreciation limits for business use of small vehicles placed in service during 2018 are as follows:

Passenger Automobiles acquired before 9/28/18 and placed in service during 2018 with § 168(k) first-year recovery:

1st Tax Year	$16,400
2nd Tax Year	$16,000
3rd Tax Year	$ 9,600
Each Succeeding Year	$ 5,760

Passenger Automobiles acquired after 9/27/17 and placed in service during 2018 with § 168(k) first-year recovery:

1st Tax Year	$18,000
2nd Tax Year	$16,000
3rd Tax Year	$ 9,600
Each Succeeding Year	$ 5,760

Passenger Automobiles placed in service during 2018 with no § 168(k) first-year recovery:

1st Tax Year	$10,000
2nd Tax Year	$16,00
3rd Tax Year	$ 9,600
Each Succeeding Year	$ 5,760

Safe Harbor of Rev. Proc. 2019-13. The revenue procedure provides a safe harbor method of accounting for determining depreciation deductions for passenger automobiles (other than leased vehicles) that are acquired after September 27, 2017, qualify for 100 percent bonus depreciation under § 168(k), have a cost (before any § 179 deduction) that exceeds the first-year § 280F limitation, and for which the taxpayer does *not* elect to take a § 179 deduction. A taxpayer adopts this safe harbor method by applying it on its federal tax return for the first taxable year succeeding the year in which a passenger automobile is placed in service. To use the safe harbor, a taxpayer must: (1) use the appropriate optional depreciation table (available in IRS Publication 946) to calculate depreciation deductions for the passenger automobile, (2) deduct the § 280F first-year limitation amount in the year the vehicle is placed in service (a figure published annually by the IRS), (3) calculate depreciation for the passenger automobile for each succeeding taxable year in the recovery period by multiplying the remaining adjusted depreciable basis (the vehicle's cost before any § 179 deduction less the § 280F first-year limitation amount) by the percentage specified in the appropriate optional depreciation table, subject to the § 280F limitation amounts, and (4) deducting any remaining basis of the vehicle in the first taxable year succeeding the end of the recovery period, subject to the limitation of § 280F(a)(1)(B)(ii) ($5,760 in the tables above) and carrying forward any excess to the succeeding taxable year to deduct in a similar manner. If § 280F(b) applies to the vehicle, i.e., if it is not predominantly used in a qualified business use, then the safe harbor ceases to apply in the first taxable year in which § 280F(b) applies. The revenue procedure is effective on February 13, 2019.

Examples. The revenue procedure provides the following examples.

Example 1 - Application of § 280F(a) safe harbor method of accounting. In 2018, X, a calendar-year taxpayer, purchased and placed in service for use in its business a new passenger automobile that costs $60,000. The passenger automobile is 5-year property under § 168(e), is qualified property under § 168(k) for which the 100-percent additional first-year depreciation deduction is allowable, and is used 100 percent in X's trade or business. X does not claim a § 179 deduction for the passenger automobile and does not make an election under § 168(b), (g)(7), or (k). X depreciates the passenger automobile under the general depreciation system by using the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. X adopts the safe harbor method of accounting provided in section 4.03 of this revenue procedure. As a result:

(a) X must use the applicable optional depreciation table that corresponds with the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention, for determining the depreciation deductions for the passenger automobile (see Table A-1 in Appendix A of IRS Publication 946);

(b) For 2018, X deducts depreciation of $18,000 for the passenger automobile, which is the depreciation limitation for 2018 under § 280F(a)(1)(A)(i) (see Table 2 in Rev. Proc. 2018-25). As a result, the remaining adjusted depreciable basis of the passenger automobile as of January 1, 2019, is $42,000 ($60,000 unadjusted depreciable basis less $18,000 depreciation deduction claimed for 2018);

(c) For 2019 through 2023, the total depreciation allowable for the passenger automobile for each taxable year is determined by multiplying the annual depreciation rate in the applicable optional depreciation table by the remaining adjusted depreciable basis of $42,000, subject to the limitation under § 280F(a)(1)(A) for that year. Accordingly, for 2019, the total depreciation allowable for the passenger automobile is $13,440 (32 percent multiplied by the remaining adjusted depreciable basis of $42,000). Because this amount is less than the depreciation limitation of $16,000 for 2019 (see Table 2 in Rev. Proc. 2018-25), X deducts $13,440 as depreciation on its federal income tax return for the 2019 taxable year. For 2020, the total depreciation allowable for the passenger automobile is $8,064 (19.20 percent multiplied by $42,000). Because this amount is less than the depreciation limitation of $9,600 for 2020 (see Table 2 in Rev. Proc. 2018-25), X deducts $8,064 as depreciation on its federal income tax return for the 2020 taxable year. Below is a table showing the depreciation allowable for the passenger automobile under the safe harbor method of accounting for the 2018 through 2023 taxable years. X deducts these amounts.

Taxable Year	Depreciation limitations under Table 2 of Rev. Proc. 2018-25	Depreciation deduction under the safe harbor
2018	$18,000	$18,000
2019	$16,000	$13,440 ($42,000 x .32)
2020	$9,600	$8,064 ($42,000 x .1920)
2021	$5,760	$4,838 ($42,000 x .1152)
2022	$5,760	$4,838 ($42,000 x .1152)
2023	$5,760	$2,419 ($42,000 x .0576)
TOTAL		$51,599

(d) As of January 1, 2024 (the beginning of the first taxable year succeeding the end of the recovery period), the adjusted depreciable basis of the passenger automobile is $8,401 ($60,000 unadjusted depreciable basis less the total depreciation allowable of $51,599 for 2018-2023 (see above table)). Accordingly, for the 2024 taxable year, X deducts depreciation of $5,760 for the passenger automobile (the lesser of the adjusted depreciable basis of $8,401 as of January 1, 2024, or the § 280F(a)(1)(B)(ii) limitation of $5,760).

(e) As of January 1, 2025, the adjusted depreciable basis of the passenger automobile is $2,641 ($8,401 adjusted depreciable basis as of January 1, 2024, less the depreciation claimed of $5,760 for 2024). Accordingly, for the 2025 taxable year, X deducts depreciation of $2,641 for the passenger automobile (the lesser of the adjusted depreciable basis of $2,641 as of January 1, 2025, or the § 280F(a)(1)(B)(ii) limitation of $5,760).

Example 2 – Section 179 deduction claimed. The facts are the same as in Example 1, except X elects to treat $18,000 of the cost of the passenger automobile as an expense under § 179. As a result, this passenger automobile is not within the scope of this revenue procedure pursuant to section 3.01(4) of this revenue procedure. Accordingly, the safe harbor method of accounting in section 4.03 of this revenue procedure does not apply to the passenger automobile. For 2018, the 100-percent additional first-year depreciation deduction and the § 179 deduction for this passenger automobile is limited to $18,000 under § 280F(a)(1)(A)(i) (see Table 2 of Rev. Proc. 2018-25). Therefore, for 2018, X deducts $18,000 for the passenger automobile under § 179, and X deducts

the excess amount of $42,000 beginning in 2024, subject to the annual limitation of $5,760 under § 280F(a)(1)(B)(ii).

Example 3 – Section 168(k)(7) election made. The facts are the same as in Example 1, except X makes an election under § 168(k)(7) to not claim the 100-percent additional first-year depreciation deduction for 5-year property placed in service during 2018. As a result, the 100-percent additional first-year depreciation deduction is not allowable for the passenger automobile. Accordingly, the passenger automobile is not within the scope of this revenue procedure pursuant to section 3.01(2) of this revenue procedure, and the safe harbor method of accounting in section 4.03 of this revenue procedure does not apply to the passenger automobile. For 2018 and subsequent taxable years, X determines the depreciation deductions for the passenger automobile in accordance with the general depreciation system of § 168(a), subject to the § 280F(a) limitations.

3. We suppose it makes sense that racehorses have a swift recovery period. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title I, § 114 of the 2020 Further Consolidated Appropriations Act, retroactively extended the § 168(e)(3)(A)(i) classification of racehorses as 3-year MACRS property so that the classification applies to racehorses placed in service before January 1, 2021. A racehorse placed in service after December 31, 2020, qualifies for the 3-year recovery period only if it is more than two years old when placed in service. This provision allowing classification of all racehorses as 3-year property regardless of age had expired for racehorses placed in service after December 31, 2017.

4. Good news for those who placed motorsports entertainment complexes in service during 2018 and 2019 or who will do so in 2020. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title I, § 115 of the 2020 Further Consolidated Appropriations Act, retroactively extended the § 168(e)(3)(C)(ii) classification of motorsports entertainment complexes as 7-year property to include property placed in service through December 31, 2020. *See* § 168(i)(15)(D). Such property is depreciable over a 7-year recovery period using the straight-line method. This provision had expired for property placed in service after December 31, 2017.

F. Credits

1. A three-year credit for small employers that implement automatic contribution arrangements. A provision of the SECURE Act, Division O, Title I, § 105 of the 2020 Further Consolidated Appropriations Act, added new Code § 45T, which provides a $500 credit to certain small employers that implement an eligible automatic contribution arrangement (as defined in § 414(w)(3)) in a qualified employer plan (as defined in § 4972(d)). Generally, an automatic contribution arrangement allows an employer automatically to deduct elective deferrals from an employee's wages unless the employee makes an election not to contribute or to contribute a different amount. The credit is available for each of three years to an "eligible employer," which is defined in § 408(p)(2)(C)(i) as an employer that has 100 or fewer employees who received at least $5,000 of compensation from the employer for the preceding year. An eligible employer can include the credit among the credits that are components of the general business credit under § 38(b). New § 45T applies to taxable years beginning after December 31, 2019.

2. Congress gives a "thumbs up" to new energy efficient homes. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title I, § 129 of the 2020 Further Consolidated Appropriations Act, retroactively extended the § 45L credit of $2,000 or $1,000 (depending on the projected level of fuel consumption) an eligible contractor can claim for each qualified new energy efficient home constructed by the contractor and acquired by a person from the contractor for use as a residence during the tax year. As extended, the credit is available for homes acquired before January 1, 2021. This provision had expired for homes acquired after December 31, 2017.

3. Congress has extended through 2020 the credit for employers that pay wages to certain employees during periods of family and medical leave. A provision of the Taxpayer

Certainty and Disaster Tax Relief Act of 2019, Division Q, Title I, § 142 of the 2020 Further Consolidated Appropriations Act, extended through December 31, 2020, Code § 45S, which was enacted by the 2017 Tax Cuts and Jobs Act. Section 45S provides that an "eligible employer" can include the "paid family and medical leave credit" among the credits that are components of the general business credit under § 38(b). The credit is equal to a percentage of the amount of wages paid to "qualifying employees" during periods in which the employees are on family and medical leave. The credit is available against both the regular tax and the alternative minimum tax.

Amount of the credit. To be eligible for the credit, the employer must pay during the period of leave at a rate that is at least 50 percent of the wages normally paid to the employee. The credit is 12.5 percent of the wages paid, increased by 0.25 percentage points for each percentage point by which the rate of payment exceeds 50 percent. The maximum credit is 25 percent of wages. Thus, if an employer pays an employee at a rate that is 60 percent of the employee's normal wages, the credit is 15 percent of wages paid (12.5 percent plus 2.5 percentage points). The credit reaches 25 percent when the employer pays at a rate that is 100 percent of employee's normal wages. The credit cannot exceed the amount derived from multiplying the employee's normal hourly rate by the number of hours for which the employee takes leave. The compensation of salaried employees is to be prorated to an hourly wage under regulations to be issued by the Treasury Department. The maximum amount of leave for any employee that can be taken into account for purposes of the credit is twelve weeks per taxable year.

Eligible employer. An eligible employer is defined as one who has in place a written policy that (1) allows all full-time "qualifying employees" not less than two weeks of annual paid family and medical leave, and that allows all part-time qualifying employees a commensurate amount of leave on a pro rata basis, and (2) requires that the rate of payment under the program is not less than 50 percent of the wages normally paid to the employee.

Eligible employee. An eligible employee is defined as any employee as defined in section 3(e) of the Fair Labor Standards Act of 1938 who has been employed by the employer for one year or more and who, for the preceding year, had compensation not in excess of 60 percent of the compensation threshold for highly compensated employees. For 2019, the threshold for highly compensated employees (see § 414(q)(1)(B)) was $125,000. Thus, for purposes of determining the credit in 2020, an employee is an eligible employee only if his or her compensation for 2019 did not exceed $75,000 ($125,000 * 60 percent).

Family and medical leave. The term "family and medical leave" is defined as leave described under sections 102(a)(1)(a)-(e) or 102(a)(3) of the Family and Medical Leave Act of 1993. (Generally, these provisions describe leave provided because of the birth or adoption of a child, because of a serious health condition of the employee or certain family members, or because of the need to care for a service member with a serious injury or illness.) If an employer provides paid leave as vacation leave, personal leave, or other medical or sick leave, this paid leave is not considered to be family and medical leave.

No double benefit. Pursuant to Code § 280C(a), no deduction is allowed for the portion of wages paid to an employee for which this new credit is taken. Thus, if an employer pays $10,000 to an employee and takes a credit for 25 percent, or $2,500, the employer could deduct as a business expense only $7,500 of the wages.

Effective date. The credit is available for wages paid in taxable years beginning after December 31, 2017, and before January 1, 2021.

4. Employers who retained employees despite becoming inoperable in areas affected by qualfied disasters are eligible for a 40 percent employee retention credit. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title II, § 203 of the 2020 Further Consolidated Appropriations Act, provides that an "eligible employer" can include "the 2018 through 2019 qualified disaster employee retention credit" among the credits that are components of the general business credit under § 38(b). The credit is equal to 40 percent of "qualified wages" for each "eligible employee." The cap on the amount of qualified wages of an employee that can be taken into account is $6,000 (reduced by the amount of qualified wages with respect to the employee that

may be taken into account for any prior taxable year). Thus, the maximum credit per employee is $2,400. An *eligible employer* is an employer that conducted an active trade or business in a qualified disaster zone at any time during the incident period of the relevant qualified disaster, if the trade or business became inoperable at any time during the period beginning on the first day of the incident period of the qualified disaster and ending on December 20, 2019 (the date of enactment) as a result of damage sustained by reason of such qualified disaster. The term *eligible employee* is defined as an employee whose principal place of employment with an eligible employer, determined immediately before the relevant qualified disaster, was in the disaster zone of that qualified disaster. The term *qualified wages* means wages (as defined in § 51(c)(1), but without regard to § 3306(b)(2)(B)) paid or incurred by an eligible employer with respect to an eligible employee during the period beginning on the date the trade or business first became inoperable at the employee's principal place of employment and ending on the earlier of (1) the date on which the trade or business resumed significant operations at the principal place of employment, or (2) the date that is 150 days after the last day of the incident period of the relevant qualified disaster. Wages can be qualified wages regardless of whether the employee performed no services, performed services at a different location, or performed services at the employee's principal place of employment before significant operations resumed. An employee is not considered an eligible employee if the employer is allowed a credit with respect to the employee under § 51(a), i.e., an eligible employer cannot claim the 40 percent credit with respect to an employee for any period if the employer is allowed a Work Opportunity Tax Credit with respect to the employee under § 51 for that period.

Several key terms are defined in Division Q, Title II, § 201 of the 2020 Further Consolidated Appropriations Act. These are as follows:

1. The term "*incident period*" with respect to any qualified disaster is the period specified by FEMA as the period during which the disaster occurred, except that the period cannot be treated as beginning before January 1, 2018, or ending after January 19, 2020 (the date that is 30 days after the date of enactment of the legislation).
2. The term "*qualified disaster zone*" is the portion of the qualified disaster area determined by the President to warrant individual or individual and public assistance from the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of the qualified disaster with respect to the qualified disaster area.
3. The term "*qualified disaster area*" is an area with respect to which the President declared a major disaster from January 1, 2018, through February 18, 2020 (the date that is 60 days the date of enactment of the legislation), under section 401 of the Stafford Act if the incident period of the disaster began on or before December 20, 2019 (the date of enactment). To avoid providing double benefits, the legislation excludes the California wildfire disaster area, for which similar relief was provided by the Bipartisan Budget Act of 2018.
4. "The term '*qualified disaster*' means, with respect to any qualified disaster area, the disaster by reason of which a major disaster was declared with respect to such area."

G. Natural Resources Deductions & Credits

H. Loss Transactions, Bad Debts, and NOLs

1. The Eleventh Circuit has reversed a federal district court and held that the government failed to establish that an individual who reimbursed her ex-husband for federal taxes could not determine her tax liability under § 1341 for the year she paid the reimbursement. Mihelick v. United States, 927 F.3d 1138 (11th Cir. 6/18/19). The taxpayer, Nora Mihelick, and her former husband, Michael Bluso, divorced in 2005. During their marriage, they had both worked at Gotham Staple Company, a closely held Ohio corporation owned by her ex-husband's family and for which her ex-husband served as chief executive officer. While their divorce was pending, her ex-husband's sister, a minority shareholder in Gotham Staple Company, sued the taxpayer's ex-husband and asserted claims of breach of fiduciary duty on the basis that he had excessively compensated

himself at Gotham's expense. Although the taxpayer initially resisted it, she and her ex-husband negotiated a provision in their separation agreement under which any liability arising from the litigation over her ex-husband's alleged breach of fiduciary duty would be a marital liability for which they would be jointly and severally liable because, if such a liability came into existence, it would arise from the acquisition of marital assets during their marriage. In 2007, the taxpayer's ex-husband settled the litigation pending against him and paid $600,000. The taxpayer resisted reimbursing her ex-husband but, after being advised by her attorney that she had an obligation to do so, she paid him $300,000 in 2009. Her ex-husband determined his liability for federal income tax for the year in which he made the $300,000 settlement payment by applying § 1341, which, if certain requirements are met, allows a taxpayer who must repay an amount previously included in income either to deduct the amount repaid or take a tax credit for the amount of tax overpaid in the year the income was included. On the taxpayer's federal income tax return for 2009, the year in which she reimbursed her former husband, she determined her tax liability by applying § 1341 and claimed a refund, which the IRS denied. Following the denial of her refund claim, the taxpayer brought this legal action seeking a refund in U.S. District Court. The District Court concluded that the taxpayer did not satisfy all requirements to determine her tax liability under § 1341, granted summary judgment for the government, and the taxpayer appealed. In an opinion by Judge Rosenbaum, the Eleventh Circuit held that the evidence supported the conclusion that the taxpayer satisfied all of the elements of § 1341 and that it was inappropriate for the District Court to grant summary judgment in favor of the government. The Eleventh Circuit remanded to the District Court to determine whether there was any genuine issue of material fact concerning any of the elements of § 1341 and, if not, to enter judgment in favor of the taxpayer. If the District Court concludes that there is a genuine issue of material fact, then the case must proceed to trial. In either case, if the taxpayer prevails, she will be entitled to determine her tax liability for 2009 by choosing whichever of the following will provide her with the better result: (1) deducting the $300,000 she paid to her former husband in 2009, or (2) hypothetically recalculating her tax liability for the prior year in which she included the $300,000 in gross income by omitting the $300,000 from gross income, determining the amount by which her tax liability would have been reduced in that year, and taking the amount of the reduction as a credit in 2009. To obtain the benefit of § 1341, four requirements must be satisfied. The court analyzed these requirements as follows:

The *first requirement* is that the taxpayer must have *included an item in gross income for a prior year* "because it *appeared that the taxpayer had an unrestricted right to such item*." The government argued that this requirement was not met because the taxpayer's former husband had no unrestricted right to the income in the year the couple included it in gross income because he had misappropriated the funds, and therefore she could not have had an unrestricted right to the income. The court rejected this argument because there was no proof her former husband had misappropriated the funds and the settlement agreement that resolved the litigation against him expressly disclaimed any wrongdoing. The court similarly rejected the argument that the taxpayer had no unrestricted right to her former husband's income under the provisions of Ohio law concerning marital property: "What matters is whether [the taxpayer] sincerely believed she had a right to Bluso's income, not the correctness of her belief." The court concluded that there was enough evidence in the record to support the taxpayer's sincere belief that she had an unrestricted right to his income in the years they were married.

The *second requirement* for a taxpayer to use § 1341 is that the *taxpayer must have later learned that she actually "did not have an unrestricted right" to that income*. According to the court, "[t]o make this showing, the taxpayer must demonstrate that she involuntarily gave away the relevant income because of some obligation, and the obligation had a substantive nexus to the original receipt of the income." The court concluded that both aspects of this requirement were satisfied. In doing so, the court rejected the government's argument that the fact that the taxpayer had reimbursed her former husband and had not paid her portion of the liability directly to the opposing party in the lawsuit precluded her from satisfying this requirement.

The *third requirement* of § 1341 is that *the amount the taxpayer did not have an unrestricted right to* and repays *must have exceeded $3,000*. The parties agreed that this requirement was satisfied.

The *final requirement* of § 1341 is that *the amount the taxpayer did not have an unrestricted right to* and repays *must be deductible under another provision of the Internal Revenue Code*. The court held that this requirement was met because her former husband was entitled to deduct the payment as a loss under § 165(c)(1) (losses incurred in a trade or business) and, by extension, the taxpayer was as well.

I. At-Risk and Passive Activity Losses

1. The taxpayer materially participated in an activity even when though some of his hours were not hours when he was physically present at the business location. Barbara v. Commissioner, T.C. Memo. 2019-50 (5/13/19). The taxpayers, a married couple, resided in Florida. The husband had owned and managed Barbara Trucking, a Chicago-area garbage-collection and waste-management business, which he sold for millions of dollars. He used the proceeds of the sale to start a lending business. The business had an office in Chicago with two full-time employees. Mr. Barbara divided his time between Florida and Chicago, spending 40 percent of his time in Chicago and 60 percent in Florida. He performed all executive functions for the lending business and worked 200 days per year. While in Chicago, he devoted 5.75 hours per day to the business and while in Florida devoted 2 hours per day. The IRS proposed various adjustments for the returns filed by the taxpayers for 2009 through 2012. One issue in the cases was whether Mr. Barbara had materially participated in the lending business during these years. The Tax Court (Judge Morrison) held that he had materially participated. The court framed the question as whether Mr. Barbara had materially participated in the business under the seventh test in Reg. § 1.469-5T(a), which requires that the taxpayer participate more than 100 hours in the activity during the year and that the taxpayer's participation be "regular, continuous, and substantial." The court calculated that Mr. Barbara had devoted 460 hours per year while in Chicago (200 days * 40 percent * 5.75 hours) and 240 hours per year while in Florida (200 days * 60 percent * 2.0 hours), or a total of 700 hours, which more than met the 100-hour requirement. The court also concluded that his participation was regular, continuous, and substantial.

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. "Bitcoin is not a currency." "No surprise" says Professor Omri Marian.[1] Notice 2014-21, 2014-16 I.R.B. 938 (3/25/14). This Notice "describes how existing general tax principles apply to transactions using virtual currency." The notice has two main components: (1) a substantive part (i.e., how Bitcoin transactions should be taxed), and (2) an information reporting part (i.e., how income on Bitcoin transactions should be reported and how tax can be collected).

Substance. The substantive part of the Notice provides very few surprises. The most important conclusions are as follows.

(1) Bitcoin is *not* a currency for tax purposes; it is property. As such, gain and losses on the disposition of Bitcoins can never be "exchange gain or loss." This may come as a disappointment to taxpayers who lost money in Bitcoin investments and may have hoped to have the losses classified as exchange-losses, and, as such, as ordinary losses. On the other hand, taxpayers who have disposed of appreciated investment positions in Bitcoins may enjoy capital gains treatment. Taxpayers who hold Bitcoin as inventory will be subject to ordinary gains and losses upon disposition.

[1] This discussion of Notice 2014-21 is adapted, with permission, from a TaxProf Blog op-ed by Profesor Omri Y. Marian, who at the time was a member of the faculty of the University of Florida Levin College of Law (and now is a member of the faculty at the University of California Irvine School of Law), on March 26, 2014, available at http://taxprof.typepad.com/taxprof_blog/2014/03/marian-bitcoin.html. We thank Prof. Marian for granting us permission to include his work in this outline. See also Omri Y. Marian, *Are Cryptocurrencies 'Super' Tax Havens?*, 112 MICHIGAN LAW REVIEW FIRST IMPRESSIONS 38 (2013).

(2) The receipt of Bitcoin in exchange for goods and services is taxable at the time of receipt. The amount realized is the U.S. dollar value of the Bitcoins received. The disposition of Bitcoin in exchange for goods and services is a realization and recognition event to the extent the value of Bitcoin has changed since the time it was acquired. Thus, if a taxpayer bought 1 Bitcoin for $500, and later used 1 Bitcoin to purchase a TV when Bitcoin was trading at $600, the taxpayer has a taxable gain of $100.

- This part of the Notice has attracted some criticism from several commentators. A New York Times article summarized this critique, noting that characterizing Bitcoin as property "could discourage the use of Bitcoin as a payment method. If a user buys a product or service with Bitcoin, for example, the IRS will expect the individual to calculate the change in value from the date the user acquired the Bitcoin to the date it was spent. That would give the person a basis to calculate the gains—or losses—on what the IRS is now calling property." This criticism is partially justified, although the result would have generally been the same had the IRS decided to classify Bitcoin as a foreign currency. Under current law, U.S. taxpayers whose functional currency is the U.S. dollar (practically all U.S. taxpayers), must track their basis in any foreign currency they hold, and recognize exchange gain or loss as soon as they dispose of the currency, but only to the extent their exchange gain or loss exceeds $200. Thus, the criticism might have some merit, as capital gains or losses are taxed from the first dollar, while exchange gain or losses are subject to the $200 threshold. This could be corrected if a de-minimis threshold would be made applicable to Bitcoin transactions as well, but it is not clear that there is any legal basis for the IRS to do so. The only way to completely avoid taxation upon disposition of Bitcoin is to characterize it as a functional currency, which could only conceivably happen if the U.S. adopts Bitcoin as a legal tender. This is much to ask for, and certainly not within the power of the IRS to decide.

(3) Since taxes are paid in U.S. dollars and not in Bitcoin, the Bitcoin value must be converted to U.S. dollars for purposes of determining gains and losses. Fair market value is determined by reference to the BTC/USD price quoted in an online exchange if "the exchange rate is established by market supply and demand." The problem with this determination is that there are multiple such exchanges, and the BTC/USD spot price may vary significantly among such exchanges. In March, 2013, the price difference between various exchanges varied by as much as $100, for an average trading price across exchanges of about $575. Taxpayers could cherry-pick their BTC/USD exchange rate and reduce tax gains or increase tax losses. The Notice prescribes that BTC to USD conversion must be made "in a reasonable manner that is consistently applied." It is not clear what "consistency" means in this context and more guidance on this issue is needed.

(4) Mined Bitcoins are includable in gross income, and thus taxed, upon receipt. Bitcoins come into existence by a mining process. "Miners" use their computing resources to validate Bitcoin transactions, and in return are compensated with newly created Bitcoin. Unsurprisingly, the IRS concluded that such income is taxable upon receipt.

- The IRS did not explicitly rule on the character of mining income, but it is most likely ordinary, under several possible theories: (a) It is income from services – Miners are paid in newly generated Bitcoin for handling the bookkeeping of the Bitcoin public ledger. The IRS describes mining income as income received from using "computer resources to validate Bitcoin transactions and maintain the public Bitcoin transaction ledger." This may imply that the IRS views mining income as income from the provision of services. (b) It is wagering income – from a technical point of view mining is guessing the correct answer to a complex cryptographing problem. (c) Mining pools – most miners mine through mining pools, where multiple individual miners pool together their computing resources in order to generate Bitcoins. Mining pools might be classified as partnerships for tax purposes. If the mining pool is a partnership – the mining pool itself is clearly in the business of mining Bitcoins. Any income from a trade or business of the partnership (the pool) passes through as ordinary income to the partners (the miners). If the mining pool is not a partnership – miners essentially rent out their computing capacity to the mining pool's operator. Rental income is ordinary income.

Information reporting and backup withholding. The Notice, as expected, also concludes that payments in Bitcoins are subject to information reporting and backup withholding. Thus, a person who in the course of trade or business makes Bitcoin payments in excess of $600 to a non-exempt U.S.

person, must report such payments to the IRS and to the recipient on the applicable Form 1099. The payments are also subject to backup withholding to the extent the payor is unable to solicit the requisite tax information from the payee.

- This interpretation is perfectly reasonable, but its practical significance is left to be seen. The U.S. information reporting system is built, among others, on the assumption that parties to a taxable transaction know each other (or can reasonably obtain information about one another and send information to each other). As such, for example, taxpayers can send Forms 1099 to each other. The operation of Bitcoin defeats this assumption. Bitcoin is specifically designed to allow for exchange of value without having the parties to a transaction ever know each other. In fact, a Bitcoin payor is not always in a position to know whether payments he or she makes are made to the same person, or to different people. Payors may have a hard time even deciding whether the $600 threshold is met. The default is backup withholding. It is not clear, however, how the IRS can enforce reporting and withholding requirements when both parties to a transaction are anonymous both to the IRS and to each other. The ramifications may be significant. Consider for example mining pools. In order to be in compliance, U.S. based mining pools would have to identify their participants by name (rather than by anonymous address), a result that the Bitcoin community is all but certain to dislike. The alternative – backup withholding by the pool operator in respect of the Bitcoin mined – would probably drive Bitcoin miners to mining pools operated by non-U.S. taxpayers. It will be interesting to see how these requirements pan out.

Unaddressed issues. The IRS is well aware of the limited breadth of the Notice and it has solicited comments from taxpayers. Some specific issues not addressed by the Notice that may be of significance are as follows: (1) Whether Bitcoin and Bitcoin-wallets are financial assets and financial accounts, respectively, for purposes of FATCA and FBAR reporting requirements. This may not be of immediate relevance to most taxpayers due to the dollar amount thresholds applicable in such contexts, but as Bitcoin grows in popularity, such issues may become relevant. (2) Whether Bitcoin service providers (such as wallet service providers, Bitcoin exchanges, Bitcoin mining pools and so on) are financial institutions for reporting, withholding, and FATCA purposes. (3) Whether Bitcoin mining pools are entities for tax purposes. Some Bitcoin mining pools may conceivably be classified as entities separate from their owners for tax purposes, and as such may qualify as partnerships. This may carry with it significant tax consequences to Bitcoin miners. (4) Can Bitcoin be classified as a commodity for purposes of section 475(e), allowing dealers to elect mark-to-market accounting?

Summary. The IRS guidance is clear, concise, and correct on the law. While some obscurities remain, most major interpretative issues are addressed. The Notice does an excellent job explaining how transactions involving Bitcoin are taxed. It got all of the substantive issues right. In the context of information reporting, however, the Notice exposes the limitations of current tax law when it comes to collecting tax on Bitcoin transactions. While the IRS got the information reporting part right as well, the practical ability of the IRS to enforce such requirements may be limited in certain contexts. The main challenge remains in the area of collection. Time will tell whether the arsenal at the disposal of the IRS is enough to deal with tax evasion through Bitcoin, or whether Congress will have to supply the IRS with additional ammo.

a. Are virtual currency accounts reportable on the FBAR? In an IRS webinar broadcast on June 4, 2014, an IRS program analyst in the Small Business/Self Employed Division stated that the IRS and the Treasury Department's Financial Crimes Enforcement Network (FinCen) have "been closely monitoring developments around virtual currencies" such as Bitcoin. However, "for right now, FinCen has said that virtual currency is not going to be reportable on the FBAR, at least for this filing season. That could change in the future, as we monitor what's happening with virtual currencies … ." See *Virtual Currency May Be Reportable on FBAR in Future*, 2014 TNT 108-2 (6/5/14). More recently, according to the Journal of Accountancy, the AICPA Virtual Currency Task Force reached out to FinCEN regarding this issue, and

> FinCEN responded that regulations (31 C.F.R. § 1010.350(c)) do not define virtual currency held in an offshore account as a type of reportable account. Therefore, virtual currency is not reportable on the FBAR, at least for now.

Kirk Phillips, *Virtual currency not FBAR reportable (at least for now)*, J. Accountancy (6/19/19).

b. The IRS has announced a virtual currency compliance campaign. On July 2, 2018, the IRS announced on its website as one of five large business and international compliance campaigns a virtual currency campaign. The website describes the campaign as follows:

> The Virtual Currency Compliance campaign will address noncompliance related to the use of virtual currency through multiple treatment streams including outreach and examinations. The compliance activities will follow the general tax principles applicable to all transactions in property, as outlined in Notice 2014-21. The IRS will continue to consider and solicit taxpayer and practitioner feedback in education efforts, future guidance, and development of Practice Units. Taxpayers with unreported virtual currency transactions are urged to correct their returns as soon as practical. The IRS is not contemplating a voluntary disclosure program specifically to address tax non-compliance involving virtual currency.

c. The IRS has begun sending letters to taxpayers with virtual currency transactions who potentially failed to report their transactions properly. IR-2019-132 (7/26/19). The IRS announced that it has begun sending letters to taxpayers with virtual currency transactions who potentitally failed to report income or otherwise report the transactions properly. The IRS expected tht more than 10,000 taxpayers would recive the letters by the end of August 2019. The IRS urged those receiving the letters to take them very seriously and to take corrective action by amending returns and paying any tax and penalties due. The announcement stated that the "[t]he names of these taxpayers were obtained through various ongoing IRS compliance efforts."

d. If you are dealing with hard forks or airdrops of virtual currency you will want to read this revenue ruling. Rev. Rul. 2019-24, 2019-44 I.R.B. 1004 (10/9/19). This revenue ruling addresses whether a taxpayer has gross income as a result of either: (1) a hard fork of a cryptocurrency the taxpayer owns if the taxpayer does not receive units of a new cryptocurrency, or (2) an airdrop of a new cryptocurrency following a hard fork if the taxpayer receives units of new cryptocurrency. The ruling provides definitions of a hard fork and an airdrop, which are very technical and require a detailed undertanding of the mechanisms through which virtual currency transactions are carried out. The ruling concludes that a taxpayer does not have gross income in the first situation but does have gross income in the second.

e. The draft Schedule 1 for the 2019 Form 1040 asks about virtual currency transactions. On October 10, 2019, the IRS released a draft of Schedule 1 (Additional Income and Adjustments to Income) for the 2019 individual income tax return on Form 1040. The revised Schedule 1 asks the following question at the top of the form: "At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?"

- **Note: the Treasury Department and the IRS have finalized the regulations summarized below. T.D. 9889, Investing in Qualified Opportunity Funds, 85 Fed. Reg. 1866 (1/13/20). For highlights of the differences between the proposed and final regulations, see https://home.treasury.gov/news/press-releases/sm864.**

2. ♫♪ We're off to see the wizard, the wonderful wizard of QOZ! ♪♫ The 2017 Tax Cuts and Jobs Act, § 13823, added §§ 1400Z-1 and 1400Z-2 to the Code relating to qualified opportunity zones ("QOZs") and qualified opportunity funds ("QOFs"). New §§ 1400Z-1 and 1400Z-2 are designed to encourage investors to free up capital and invest in economically distressed census tracts (i.e., QOZs) by providing federal income tax benefits to taxpayers who realize capital gains and invest them in certain funds (i.e., QOFs) that in turn invest in businesses and real estate located in these designated communities. More than 8,700 census tracts have been designated as QOZs. There are designated QOZs in all 50 states, the District of Columbia, and several U.S. territories. These QOZs are listed by state in Notice 2018-48, 2018-28 I.R.B. 9 (6/20/18) (as updated by Notice 2019-42, 2019-29 I.R.B. 352 (6/25/19)). In October 2018, Treasury published its first set of proposed regulations under §1400Z-2 (REG-115420-18, Investing in Qualified Opportunity Funds, 83 F.R. 54279

(10/29/18), and published a second set of proposed regulations in May 2019 (REG-120186-18, Investing in Qualified Opportunity Funds, 84 F.R. 18652 (5/1/19). These two sets of proposed regulations are generally proposed to be effective on the date they are published as final regulations, but taxpayers can rely on the them before that date if applied in their entirety and in a consistent manner. New §§ 1400Z-1 and 1400Z-2 are effective December 22, 2017. To satisfy this effective date, it appears that the qualified reinvestment in a QOF must take place after December 22, 2017. *See "Opportunity Zones FAQs"* at www.irs.gov. A valuable resource for information concerning QOZs is the Economic Innovation Group at https://eig.org/opportunityzones.

- **Note:** This outline discusses the tax treatment of *investing* in a QOF, and does not address the requirements for a fund to have the status of a QOF. A QOF must be in the form of a partnership or corporation. The rules for qualifying such an entity as a QOF are detailed, technical, lengthy, and complex. In order to qualify, the entity must self-certify by filing Form 8996 ("Qualified Opportunity Fund"). It is beyond the scope of this outline to provide detailed coverage of the myriad of technical rules that a partnership or corporation must satisfy in order to be classified as a QOF. With the reported proliferation of QOFs, investors will need to use due diligence to determine whether they can rely on the representations by the fund organizers and promoters that the funds actually meet all of the technical requirements of a QOF. In addition, investors should use due diligence when analyzing whether investing in any particular QOF is economically advisable.

Taxpayers Eligible To Use § 1400Z-2. The tax benefits of investing in a QOF are set forth in § 1400Z-2. Virtually any type of taxpayer having a qualifying capital gain ("eligible gain") may qualify for the tax benefits provided by § 1400Z-2, including: individuals, C corporations (including regulated investment companies and real estate investment trusts), partnerships, S corporations, and trusts and estates. Prop. Reg. § 1.1400Z2(a)-1(b)(1). The preamble to the proposed regulations states that eligible taxpayers also include common trust funds described in § 584 as well as qualified settlement funds, disputed-ownership funds, and other entities taxable under the § 468B regulations.

Overview of Tax Incentives for Investing in "Qualified Opportunity Funds"(QOFs). The tax incentives provided by § 1400Z-2 are summarized briefly below.

(1) *Deferral of Capital Gain To Extent Invested in QOF Within 180 Days.* Generally § 1400Z-2 allows taxpayers to defer capital gains (long-term or short-term) to the extent the gains are invested in a QOF within 180 days of realizing the capital gain.

(2) *Investment In QOF Held For At Least 5 Years - 10% Exclusion.* If the investment in the QOF is held for at least five years, then the taxpayer can exclude from gross income 10 percent of the original deferred capital gain.

(3) *Investment In QOF Held For At Least 7 Years - Additional 5% Exclusion.* If the investment in the QOF is held for at least seven years, then the taxpayer can exclude from gross income an additional 5 percent of the deferred capital gain *for a total exclusion of 15 percent of the original deferred capital gain*. Because gain deferred under § 1400Z-2 is taxed upon the earlier of the date the investment in the QOF is sold (or disposed of in a taxable transaction) or December 31, 2026, a taxpayer must invest in a QOF by December 31, 2019, to meet the seven-year holding period and thereby receive the additional 5 percent exclusion.

(4) *Remaining Deferred Capital Gain Taxed No Later Than December 31, 2026.* Any remaining deferred capital gain is generally taxed on the earlier of: (1) the date the investment in the QOF is sold (or disposed of in a taxable transaction), or (2) December 31, 2026.

(5) *Investment In QOF Held For At Least 10 Years – Post-Acquisition Gain Excluded from Income*. For qualified investments in a QOF held for at least 10 years, the taxpayer may elect to exclude from gross income any gain from *post-acquisition appreciation* (i.e., may elect to increase the basis of the fund to the fair market value of the fund on the date the investment in the fund is sold or exchanged).

Acquisition of a Qualifying QOF Interest. The discussion of investment in QOFs discussed in this outline assumes that the taxpayer invested cash in the QOF, because it is generally presumed that the vast majority of investments in QOFs will be in cash. However, the proposed regulations provide detailed guidelines for how these rules would operate if the taxpayer transferred non-cash property in return for a qualifying QOF interest. See Prop. Reg. § 1.1400Z2(a)-1(b)(9). A taxpayer may not acquire a qualifying QOF interest in return for providing *services* to the QOF. Prop. Reg. § 1.1400Z2(a)-1(b)(9)(ii). A taxpayer can acquire a qualifying QOF interest from someone other than the QOF. Prop. Reg. § 1.1400Z2(a)-1(b)(9)(iii).

Qualifying Capital Gains Eligible for Deferral and or Exclusion. The requirements for capital gains to be eligible for deferral or exclusion are summarized below.

(1) *"Capital" Gains Eligible For Deferral Treatment Under § 1400Z-2.* Prop. Reg. § 1.1400Z2(a)-1(b)(2) provides that a gain eligible for deferral or exclusion treatment under § 1400Z-2 ("eligible gain") is generally a gain that: (1) is "treated as capital" for federal income tax purposes; (2) would otherwise have been recognized for federal income tax purposes before January 1, 2027, except for the deferral under § 1400Z-2, and (3) does not arise from a sale or exchange with a "related party." The preamble to the proposed regulations provides that even the "capital gain" portion (if any) of a dividend would generally qualify for deferral treatment under § 1400Z-2. See Prop. Reg. § 1.1400Z2(a)-1(b)(4)(ii)(B), Example 2 for an example of the treatment of a capital gain dividend.

- Although all gains treated as "capital gains" under the Internal Revenue Code will generally be "eligible gains," there are certain limitations on capital gains from § 1256 contracts and other gains that are part of an "offsetting-position" transaction. See Prop. Reg. § 1.1400Z2(a)-1(b)(2)(iii)(B) and -1(b)(2)(iv) for details.

(2) *Short-Term CapitalGains.* There is no prohibition for qualifying short-term capital gains. However, if a short-term capital gain is deferred by a qualifying investment in a QOF, when the deferred gain is ultimately recognized, it will retain its short-term capital gain treatment. Prop. Reg. § 1.1400Z2(a)-1(b)(5).

(3) *Gains Arising from a Sale to a "Related Party" Do Not Qualify.* For this purpose, persons are related to each other if they are described in § 267(b) or § 707(b), determined by substituting 20 percent for 50 percent wherever it appears in those sections. § 1400Z-2(e)(2).

(4) *Capital Gains to Owners Resulting from Operating or Liquidating Distributions from Their C Corporations, S Corporations, or Partnerships.* Generally, a capital gain is triggered under § 301 or § 731 if a C corporation, S corporation, or partnership makes an actual or deemed cash distribution in excess of the owner's basis in the stock or partnership interest. A capital gain from such a distribution should generally be an "eligible gain"f or purposes of deferral under § 1400Z-2. However, if the distributee-owner and the distributing entity meet the 20 percent ownership test for "related parties" discussed above (a fairly common situation), the gain on the distribution would not qualify for deferral.

(5) *Capital Gains Under § 1231.* Prop. Reg. § 1.1400Z2(a)-1(b)(2)(iii) states: "*The only gain arising from section 1231 property* that is eligible for deferral under section 1400Z-2(a)(1) is *capital gain net income* for a taxable year. This net amount is determined by taking into account the capital gains and losses for a taxable year on all of the taxpayer's section 1231 property. The *180-day [Reinvestment] Period .....* with respect to *any capital gain net income from section 1231 property* for a taxable year *begins on the last day of the taxable year."* (Emphasis added.)

(a) *Property Subject to § 1231.* Generally, § 1231 gains and losses arise from the sale or exchange or compulsory or involuntary conversion of "property used in a trade or business." Section 1231(b)(1) generally defines "property used in a trade or business" as property used in a trade or business that is held for more than one year that is either: (1) subject to the allowance for depreciation under § 167, or (2) real property. However, this category also includes: timber held for more than one year where the taxpayer elects to treat the cutting as a sale and timber sold with a retained economic interest under

§ 631; coal or domestic iron ore sold with a retained economic interest as described under § 631; certain livestock; and certain unharvested crops.

(b) *Section 1231 Tax Treatment.* If, for the tax year, a taxpayer's total § 1231 gains from sales or exchanges (i.e., those in the so-called "main hotchpot") exceed the taxpayer's total § 1231 losses, the gains are treated as long-term capital gains and the losses are treated as long-term capital losses. § 1231(a)(1). By contrast, if for the tax year a taxpayer's total § 1231 losses exceed the taxpayer's § 1231 gains, the gains are treated as ordinary income and the losses are treated as ordinary losses. As noted above, the proposed regulations provide that only a taxpayer's *"capital gain net income*" under § 1231 is eligible for deferral under § 1400Z-2(a)(1). The term *"capital gain net income"* seems to suggest that only the *"net"* § 1231 gain amount is eligible for deferral. Assuming this interpretation is correct, if for the tax year a taxpayer had a *single § 1231 gain of $100* and a *single § 1231 loss of ($80),* only the *net § 1231 gain* of *$20* ($100 less $80) would be eligible for deferral. However, since the entire § 1231 gain of $100 is a long-term capital gain under a literal reading of § 1231(a)(1), some have argued that the entire $100 should be available for deferral.

- Several professional groups have submitted comment letters to Treasury recommending that the final regulations clarify that once a taxpayer has a net § 1231 gain, then each *"gross"*§ 1231 gain ($100 in the above example) would be available for deferral if that amount is invested in a QOF. See *Practitioners Push Back on O-Zone Year-End Netting Rule*, Doc. 2019-25989, 2019 TNTF 129-1 (7/5/19).

(c) *180-Day Re-Investment Period For Net § 1231 Gains.* For any given tax year, whether a taxpayer has a net § 1231 gain (qualifying for deferral) cannot be determined until the end of the tax year. Consequently, as noted above, the proposed regulations provide that the 180-day reinvestment period to invest in a QOF with respect to a net § 1231 gain does not begin until the last day of the taxable year. Practice Alert! If, for example, a calendar-year taxpayer has only a single gain from the sale of a § 1231 asset during 2019, the earliest the taxpayer could purchase a qualifying interest in a QOF in order to defer the net § 1231 gain would be December 31, 2019. Presumably, unless we get further guidance on this issue, the taxpayer in this example would have to wait until December 31, 2019 to reinvest in the QOF even if the taxpayer knew in advance that there would be no § 1231 losses during the remainder of the year.

- Several professional organizations (e.g., AICPA, ABA, State Bar of Texas Tax Section) have submitted comments to Treasury recommending that the final regulations provide a more flexible 180-day period for § 1231 gains. For example, several of the comments recommended an option to start the 180-day period on the date of the sale of the § 1231 property (particularly if the taxpayer was able to predict with some certainty that it would end up with a net § 1231 gain by the end of the year). See Stephanie Cumings, *Practitioners Push Back on O-Zone Year-End Netting Rule*, Doc. 2019-25989, 2019 TNTF 129-1 (7/5/19).

(d) *Section 1231Gains Generated By PartnershipsAnd S Corporations.* Net § 1231 gains and losses generated by a pass-through entity (e.g., a partnership or S corporation) pass through to the owners as "separately stated" items. The owners (partners and S corporation shareholders) then combine the net § 1231 gains/losses that pass through with their own § 1231 gains/losses to determine whether they have an overall net § 1231 gain or a net § 1231 loss on their individual returns. Consequently, even if the pass-through entity has a net § 1231 gain at the entity level, it is entirely possible that the net § 1231 gain passing through to the owner, when combinedwith the owner's separate § 1231 losses, could ultimately be taxed to the owner as a "net" § 1231 loss.

- This treatment of net § 1231 gain passed through by a partnership or S corporation raises a question as to whether a partnership or an S corporation can make the election at the entity level to defer the net § 1231 gain (determined at the entity level) by investing in a QOF. According to media reports on the ABA Tax Section's May meeting, Bryan Rimmke an Attorney-Adviser in Treasury's Office of Tax Legislative Counsel, stated the following at the meeting (on May 10, 2019) -"the government allows a partnership to net its gains against its losses for section 1231 purposes, and if it ends up with a net gain, the partnership can elect to invest that gain into a qualified opportunity fund." It was

reported that Mr. Rimmke agreed that this netting of § 1231 gains and losses at the partnership level is allowed for purposes of reinvesting the net gain in a QOF "[e]ven if a partnership doesn't have a per se [section] 1231 netting." See Eric Yauch, *Partnerships Can Defer Section 1231 Gain Under O-Zone Rules*, Doc. 2019-18716, 2019 TNT 92-9 (5/13/19). Hopefully the IRS will provide clear guidance on this issue in the final regulations.

(e) *Impact Of Recapture Rules On Eligible § 1231 Gain.* If, and to the extent, a net § 1231 gain is recharacterized as ordinary income under the depreciation recapture provisions of § 1245 or § 1250, or under the 5-year look-back rule under § 1231(c), the ordinary income portion would not be eligible for deferral under § 1400Z-2.

- Section 1231(c) generally provides that a taxpayer's net § 1231 gain for the current year will be recharacterized as ordinary gain to the extent of the taxpayer's net § 1231 losses recognized in the preceding 5 years. However, § 1231(c) is a § 1231 loss "look-back" rule, not a § 1231 loss "look-forward" rule. To illustrate, assume that for 2019 a taxpayer: (1) has had no net § 1231 losses in the preceding 5 years, (2) in 2019 has already recognized a single § 1231 gain of $100, and (3) is now considering selling a single § 1231 asset for a loss of ($90). If the taxpayer sells the § 1231 loss asset before the end of 2019 generating a § 1231 loss of ($90), the taxpayer would have a "net" § 1231 gain for 2019 of $10 ($100 less $90) which would qualify for deferral under § 1400Z-2. However, if the taxpayer waits until 2020 to recognize the § 1231 loss of ($90), she will have a net § 1231 gain for 2019 of $100 eligible for deferral under § 1400Z-2. Moreover, if taxpayer has no other §1231 transactions in 2020 other than the § 1231 loss of ($90), she would then be able to deduct fully the ordinary loss of ($90) against all other 2020 income. In this situation, the 5-year look-back rule under § 1231(c) would not apply to 2020 because that rule applies only when there are net § 1231 losses reported in the preceding 5 years.

General Tax Benefits of Investing in Qualified Opportunity Funds (QOFs). The tax benefits provided by § 1400Z-2 for those investing in QOFs are described in more detail below.

(1) *Gain Deferral Benefits Under § 1400Z-2.* A taxpayer may defer recognition of a qualifying capital gain by investing the *amount of the gain* in a QOF within 180 days of realizing the capital gain. For example, assume that a taxpayer sold a capital asset for $100 with a basis of $10 (realizing a $90 qualifying capital gain). The taxpayer could defer 100 percent of the $90 capital gain by investing $90 (i.e., the amount of the gain) in a QOF within 180 days. The initial basis of the QOF investment acquired as a result of the reinvestment of the taxpayer's qualified capital gain is zero. § 1400Z-2(b)(2)(B)(i). So, in the above example,the taxpayer's initial basis in the QOF investment is zero, even though the taxpayer paid $90 for it.

(a) *Maximum Period Of Gain Deferral.* The deferred gain (e.g., $90 in the above example) must be recognized on the earlier of: (1) December 31, 2026 (whether or not the taxpayer sells the QOF interest), or (2) the date the taxpayer sells or exchanges the interest in the QOF. § 1400Z-2(b)(1).

(b) *Maximum Gain Recognized When Deferred Gain Triggered.* When the deferred gain is triggered, the maximum amount of deferred gain that will be recognized is the lesser of: (1) the amount of gain originally deferred, or (2) the fair market value of the QOF investment as determined on the recognition date, OVER the taxpayer's basis in the QOF investment. § 1400Z- 2(b)(2)(A). Again using the above example, assume that after four years the taxpayer sold the QOF investment for $75. This would result in a deferred gain of only $75 being riggered even though the original deferred gain was $90. This generally means that, if on the recognition date the value of the QOF interest has dropped below the initial investment amount in the QOF interest (e.g., in the above example that would be below $90), the amount of the deferred gain recognized will generally be reduced by the post-acquisition loss in value.

(2) *Reduction Of Deferred Gain Based On 5- Or 7-Year Holding Periods.* As mentioned previously, after the taxpayer holds the QOF investment for at least five years, 10 percent of the deferred gain will be excluded from the taxpayer's gross income. If the QOF investment is held at least seven years, then an additional 5 percent (a total of 15 percent) of the deferred gain will be excluded from the taxpayer's gross income. This exclusion results from the taxpayer getting an automatic increase in the basis of the QOF interest of 10 percent of the deferred gain at five years and

an additional increase of 5 percent at seven years. § 1400Z-2(b)(2)(A); § 1400Z-2(b)(2)(B)(iii) and (iv). Again using the above example, after the taxpayer has held the QOF investment for five years, her basis goes from zero to $9 (i.e., 10% of the deferred gain of $90), and after holding it for seven years her basis goes to $13.50 (i.e., 15% of the deferred gain of $90). As noted earlier, because gain deferred under § 1400Z-2 is taxed upon the earlier of the date the investment in the QOF is sold (or disposed of in a taxable transaction) or December 31, 2026, a taxpayer must invest in a QOF by December 31, 2019, to meet the seven-year holding period and thereby receive the additional 5 percent exclusion.

- *Impact of Potential Increases in Capital Gains Tax Rates.* Even in the best case scenario, 85 percent of the original deferred capital gain will be taxed no later than December 31, 2026, at whatever capital gains rates exist in 2026. If the current effective maximum long-term capital gain rate of 23.8% is increased between now and 2026, the increase in the capital gains rates would dilute the tax benefit of the tax deferral. Assuming a 15 percent deferred gain exclusion, it would appear that the top effective capital gain rate would have to be increased to above 28% (i.e., 28% x 85% equals 23.8%) before the top effective rate would be greater than the current top effective capital gain rate of 23.8%.

(3) *100% Gain Exclusion After Holding QOF for 10 Years.* After the taxpayer holds the QOF investment for at least ten years, the taxpayer can exclude 100 percent of the gain realized from the sale or exchange of the QOF interest. This gain, in essence, represents the appreciation that occurred in the QOF investment after the taxpayer purchased it. To receive the benefit of this exclusion, the taxpayer must sell the interest in the QOF before 2048. Prop. Reg. § 1.1400Z2(c)-1(b). To illustrate, recall in the above example the taxpayer sold a capital asset for $100 with a basis of $10 (realizing a $90 qualifying capital gain), and deferred the gain by investing $90 in a QOF within 180 days. If the taxpayer holds the QOF investment for at least 10 years, sells it for $150, and elects to step the basis up to the fair market value of the QOF investment on the date of the sale as provided in § 1400Z-2(c), the taxpayer could exclude 100 percent of the $60 gain (i.e., sales proceeds of $150 less the initial investment of $90 in the QOF). § 1400Z-2(c).

(a) *Generally No TaxableGain Triggered on Investment in QOF After 10-Year Holding Period.* The sale, exchange, or other disposition of a QOF investment (acquired solely to defer previous gain) that is held by the taxpayer for at least ten years should not trigger any taxable gain because: (1) all of the initial deferred gain reflected in the investment in a QOF must be fully recognized no later than December 31, 2026, and (2) 100 percent of the post-acquisition gain is excluded if the QOF investment is held at least ten years.

(b) *10-Year Rule Applies Only to QOF Investment That Allowed Taxpayer to Defer Initial Capital Gain.* The only portion of the investment in the QOF that qualifies for this 100 percent gain exclusion is the portion of the investment that allows the taxpayer to defer a previous capital gain. If a taxpayer invests in a QOF, and only a portion of the investment is used to defer a previous capital gain, then the investment in the QOF will be treated as two separate investments. § 1400Z-2(e)(1). For example, again recall the facts in the previous hypothetical where the taxpayer sold a capital asset for $100 with a basis of $10 (realizing a $90 qualifying capital gain). Assume further that the taxpayer used the entire sales proceeds of $100 to purchase an interest in a QOF for $100. In that event: (1) the QOF interest representing $90 of the purchase price (i.e., the amount of gain deferred) will be treated as a separate QOF investment and can qualify for the 100 percent exclusion if held at least ten years, and (2) the QOF interest representing $10 of the purchase price will likewise be treated as a separate QOF investment but will not qualify for the 100 percent exclusion. *See also* Prop. Reg. § 1.1400Z2(a)-1(b)(10). In this example, although the separate QOF investment represented by the $90 will qualify for the 10 percent to 15 percent bump up in basis if held five or seven years, the separate QOF investment represented by the $10 will not qualify for any basis bump. Thus, an investor who simply invests in a QOF (without attempting to use the investment to defer previously-realized capital gain) will receive no special tax treatment under § 1400Z-2 when the investor later sells the QOF interest.

(c) *QOF's Sale Of "Qualifying Ozone Business Property"After 10 Years.* Generally, § 1400Z-2 allows a taxpayer who has met the ten-year holding period requirement to exclude 100 precent of the gain resulting from the sale of the taxpayer's QOF interest. Thus, for example, if a taxpayer meeting the ten-year holding period requirement sold S corporation stock or a partnership interest

in an entity that was a QOF and elected to step up the basis to fair market value, the entire gain would be excluded. Moreover, it appears that the entire gain on the sale a QOF partnership interest would be excluded even if the partnership held so-called "hot assets"under § 751(a). See Prop. Reg. § 1.1400Z2(c)-1(b)(2)(i) for details.

- *Sale Of Assets By QOF*. The proposed regulations provide special rules for allowing an investor to exclude pass-through "capital gains" and pass-through "capital gain net income from § 1231 property" triggered by a QOF selling its qualifying ozone business property after the ten-year holding period. See Prop. Reg. § 1.1400Z2(c)-1(b)(2)(ii) for details. *Note:* Even if the ten-year holding period is satisfied, it appears that the QOF investor could not exclude pass-through ordinary gain (e.g., §1245/1250 depreciation recapture gain, cash-basis receivables, inventory gain, etc.) from the sale of the assets by the QOF. Consequently, if the investor sells an ownership interest in a QOF (S corporation stock or partnership interest) after meeting the ten-year holding period requirement, the taxpayer can exclude 100 percent of the gain. By contrast, if the QOF sells the assets of the business, any ordinary income passing through to the QOF investor will be fully taxed.

(4) *Gain Triggered On Disposition of Entire Interest in QOF May Be Deferred if Reinvested in QOF Within 180 Days, But Reinvestment Starts New Holding Period.* The preamble to the proposed regulations states:

> If a taxpayer acquires an original interest in a QOF in connection with a gain-deferral election under section 1400Z-2(a)(1)(A), if a later sale or exchange of that interest triggers an inclusion of the deferred gain, and if the taxpayer makes a qualifying new investment in a QOF, then the proposed regulations provide that the taxpayer is eligible to make a section 1400Z-2(a)(2) election to defer the inclusion of the previously deferred gain. Deferring an inclusion otherwise mandated by section 1400Z-2(a)(1)(B) in this situation is permitted only if the taxpayer has disposed of the entire initial investment ..... ."

The preamble also provides:

> [I]f an investor disposes of its entire qualifying investment in QOF 1 and reinvests in QOF 2 within 180 days, the investor's holding period for its qualifying investment in QOF 2 begins on the date of its qualifying investment in QOF 2, not on the date of its qualifying investment in QOF 1.

"Inclusion Events" That Trigger Deferred Gain. The events that trigger recognition of a taxpayer's deferred gain are described below.

(1) *Deferred Gain "Inclusion Events."* Section 1400Z-2(b)(1)(A) generally requires the deferred gain to be recognized if the investment in the QOF is "sold or exchanged" before December 31, 2026. (*Note:* The following "inclusion events" are relevant only for the deferred gain through December 31, 2026, because any deferred gain remaining after application of the five and seven year exclusion rules must be recognized no later than December 31, 2026 even if the taxpayer is still holding the QOF investment.) Prop. Reg. § 1.1400Z2(b)-1(c) includes a long list of transactions (called "inclusion events") that trigger all or a portion of the deferred gain reflected in an investment in a QOF. The list of "inclusion events"is long, technical, detailed, and the following is merely an overview of selected provisions.Generally, the"inclusion events"under the proposed regs fall into two categories: (1) certain transactions that reduce the taxpayer's equity interest in the QOF, and (2) certain distributions of property from the QOF.

(a) *Overview Of "Equity Reductions" In Taxpayer's Interest In QOF That Could Trigger Deferred Gain.* Transactions that reduce a taxpayer's equity interest (directly or indirectly) in the QOF that could trigger all or a portion of the deferred gain include: (1) dispositions of all or a portion of an interest in a QOF by sale or exchange; (2) disposition by gift (even if the donee is a tax exempt organization); (3) liquidation of the QOF; (4) certain liquidations of an owner of an interest in a QOF; (5) disposition of an interest in a partnership that is an owner in a QOF; and (6) an aggregate change in ownership in excess of 25 percent of an S corporation that holds an interest in a QOF.

- The proposed regulations also provide that the deferred gain will be triggered if a taxpayer claims a worthlessness deduction under § 165(g) with respect to a qualifying QOF investment. Prop. Reg. § 1.1400Z2(b)-1(c)(1)(i).

(b) *Overview Of Certain Distributions Of Property That Could Trigger Deferred Gain.* An inclusion event could occur whenever there is an actual or deemed distribution of property (including cash) by a QOF partnership or corporation where the distributed property has a FMV in excess of the taxpayer's basis in the QOF partnership or corporation. Prop. Reg. § 1.1400Z2(b)-1(c)(6)(iii). This could include a distribution from a QOF corporation or partnership that exceeds the owner's basis and is thus taxed as a sale or exchange under §§ 301, 731, or 1368.

(c) *More Details On Inclusion Events.* Please see Prop.Reg. § 1.1400Z2(b)-1(c) for additional details, including a complete list of inclusion events.

(2) *Overview Of Certain Transactions That Do Not Trigger Deferred Gain.* The proposed regulations also identify transactions that generally are not inclusion events, including: (1) certain transfers of an investment in a QOF upon the death of a taxpayer (however, the deferred gain is treated as income in respect of a decedent under § 691 when triggered, but the recipient receives the decedent's holding period in the QOF for purposes of the 5/7/10 year rules); (2) the contribution of an ownership interest in a QOF to a grantor trust; (3) § 721 contributions (i.e., contributions of property to a partnership in exchange for a partnership interest); (4) the election, revocation, or termination of S corporation status. Please see Prop. Reg. § 1.1400Z2(b)-1(c) for additional details, including a complete list of events that are not inclusion events.

- If certain rigid requirements are satisfied, a QOF may be able to sell all or a portion of its qualifying opportunity zone property without triggering a penalty on the QOF for failing to invest 90% of its assets in qualified OZ property if the proceeds are reinvested in qualifying opportunity zone property during a 12-month testing period. See § 1.1400Z2(f)-1(b) for details. However, it appears under the proposed regulations that any gain (including capital gains) recognized by the QOF on the sale and reinvestment of its qualified opportunity zone property will pass through and be taxed to an investor in the QOF who hasn't held his or her interest for at least 10 years. As previously discussed, if the investor has held the QOF interest for at least 10 years, the pass-through capital gains or net § 1231 gains generated by the QOF should be tax-free to the investor.

Timing and Reporting Requirements for Deferred Gains Invested In a QOF. The timing and reporting requirements for deferred gains invested in a QOF are summarized below.

(1) *The 180-Day Reinvestment Requirement.* Generally, for an eligible capital gain to be deferred under § 1400Z-2, the taxpayer must purchase a qualifying investment in a QOF no later than 180 days following the date of the sale or exchange, or other disposition that generated the eligible gain. § 1400Z-2(a)(1)(A). However, the proposed regulations provide that generally the first day of the 180-day period is the date on which the gain would be recognized for federal income tax purposes, without regard to the deferral available under § 1400Z-2. There are at least two examples where the starting date of the 180-day period begins after the date of the sale or exchange: (1) Net §1231 Gains - as discussed above, and (2) Pass-Through Entities - if a partnership or S corporation has an "eligible gain," the pass-through entity may elect to defer the gain and invest in a QOF within 180 days of the disposition. However, if the pass-through entity does not elect to defer the gain, each owner has the option to elect to defer the owner's respective portion of the pass-through eligible gain by directly investing in a QOF. In this latter situation, the beginning of the 180-day period for the owners generally begins on the last day of the pass-through entity's tax year. Please see Prop. Reg. § 1.1400Z2(a)-1(c) for details.

(2) *Election Mechanics - Form 8949.* A taxpayer must affirmatively elect to defer an eligible gain by making the election on Form 8949. The election is generally made on Form 8949 ("Sales and Other Dispositions of Capital Assets") in accordance with the Form's instructions by reporting the eligible gain and entering "Z" in column (f). In addition, the instructions to the 2018 Form 8949 provide:

> If the gain is reported on Form 8949, do not make any adjustments for the deferral in column (g). Report the deferral of the eligible gain on its own row of Form8949 in Part I with box C checked or Part II with box F checked (depending on whether the gain being deferred is short-term or long-term). If you made multiple investments in different QO Funds or in the same QO Fund on different dates, use a separate row for each investment.

(3) *IRS Says Election To Defer Gain Can Be Made On An Amended Return.* On its website, the IRS answered this question in a segment entitled "Opportunity Zones FAQs" (at www.irs.gov.) – which contains the following Q&A: "Q. Can I still elect to defer tax on that gain if I have already filed my tax return? A. Yes, but you will need to file an amended return, using Form 1040-X and attaching Form 8949."

3. Tax Court holds that individuals' amount realized from foreclosure sale of real property was bid price at foreclosure sale and, taking into account their basis in foreclosed properties, they realized a $4.3 million long-term capital loss. Breland v. Commissioner, T.C. Memo. 2019-59 (5/29/19). In both 2003 and 2004, Charles and Yvonne Breland a married couple, sold real property, deposited the proceeds with an intermediary, and acquired other real property. They treated the transactions in 2003 and 2004 as like-kind exchanges eligible for deferred recognition of gain under § 1031. One of the properties the taxpayers acquired in the like-kind exchange in 2004 was a lot on Dauphin Island, Alabama (Dauphin Island 1), for which they reported an adjusted basis of $6,689,113. In 2005, they acquired a second property on Dauphin Island (Dauphin Island 2) for $5,613,287. They financed the purchase of Dauphin Island 2 with a recourse mortgage loan from Whitney Bank in the amount of $11.2 million. The taxpayers used this loan, which was secured by both Dauphin Island 1 and Dauphin Island 2, not only to acquire Dauphin Island 2, but also to refinance indebtedness they had incurred with respect to Dauphin Island 1. In early 2009, the taxpayers defaulted on the loan from Whitney Bank, which had an outstanding balance at that time of $10.7 million. Whitney Bank foreclosed on the loan and held a foreclosure sale in 2009 at which Whitney Bank was the high bidder with a bid of $7.2 million. The taxpayers later filed for chapter 11 bankruptcy protection in federal court and Whitney Bank filed a proof of claim in that proceeding for $6.3 million. On their federal income tax return for 2009, the taxpayers initially reported a capital loss from the sale of Dauphin Island 1 and Dauphin Island 2 of $1.8 million, which they determined by treating the outstanding loan balance (approximately $10.7 million) as their amount realized and comparing it to their adjusted bases in the properties. They subsequently filed an amended return for 2009 on Form 1040X on which they reported a capital loss from the sale of Dauphin Island 1 and Dauphin Island 2 of $5.3 million, which they determined by treating the bid price at the foreclosure sale (approximately $7.2 million) as their amount realized and comparing it to their adjusted bases in the properties. The IRS challenged their determination of both their amount realized and their adjusted bases in the properties sold at the foreclosure sale. According to the IRS, the taxpayers had overstated the amount of their capital loss from the foreclosure sale.

The amount realized in the foreclosure sale was the $7.2 million bid price, not the full $10.7 million outstanding loan balance. The Tax Court (Judge Pugh) first concluded that the amount realized by the taxpayers from the 2009 foreclosure sale of Dauphin Island 1 and Dauphin Island 2 was the $7.2 million bid price for which the properties were sold, not the $10.7 million outstanding loan balance. Generally, under § 1001(b), a taxpayer's amount realized from the sale or exchange of property is the amount of money received plus the fair market value of any property received. According to Reg. § 1.1001-2(a)(1), a taxpayer's amount realized also includes the amount of any liabilities from which the taxpayer is discharged as a result of transferring the property. The Tax Court explained that this rule applies in the case of nonrecourse debt, i.e., the amount realized includes the full amount of the nonrecourse debt that is discharged by transferring property. In the case of recourse debt such as the debt in this case, however, the taxpayer's amount realized is limited to the fair market value of the property. The court relied for this proposition on Reg. § 1.1001-2(a)(2), which provides that "[t]he amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of

indebtedness under section 61(a)(12)." The court also relied on its prior decisions, including *Frazier v. Commissioner*, 111 T.C. 243 (1998), and *Aizawa v. Commissioner*, 99 T.C. 197 (1992), aff'd, 29 F.3d 630 (9th Cir. 1994). The IRS argued that the $7.2 million bid price for the Dauphin Island properties at the foreclosure sale did not establish their fair market value because the sale was compelled and not a sale between a willing buyer and a willing seller. According to the court, however, "in the case of mortgaged property sold at a foreclosure sale, we presume fair market value to be the bid price, absent clear and convincing evidence to the contrary." In this case, the court concluded, there was no clear and convincing evidence to the contrary and therefore the bid price established the fair market value of the foreclosed properties and the amount realized by the taxpayers was $7.2 million. In reaching this conclusion, the court rejected the IRS's argument that, if the bid price is treated as the amount realized, then the taxpayers should have recognized discharge of indebtedness income of approximately $5.5 million, which was the remaining loan balance. According to the court, the preponderance of the evidence including Whitney Bank's filing of a proof of claim in the taxpayers' bankruptcy proceeding, suggested that the remaining loan balance had not been discharged.

The aggregate basis the taxpayers had in the properties sold at the foreclosure sale was $11.5 million and therefore they realized a capital loss of $4.3 million. The Tax Court concluded that the taxpayers had not adequately substantiated their basis in the Dauphin Island 1 property. Specifically, the court concluded that they had not adequately substantiated their basis in the property they had exchanged in like-kind exchanges for Dauphin Island 1 and therefore had not adequately substantiated the basis that carried over to Dauphin Island 1. Accordingly, the court reasoned, their basis in Dauphin Island 1 was $5.9 million, which was the amount of money they had paid for it plus the amount of indebtedness they had incurred to purchase it, less the amount of liabilities satisfied in the transaction in which they acquired Dauphin Island 1. Their basis in Dauphin Island 2 was $5.6 million, the amount they had paid for the property. Therefore, their aggregate basis in the two properties was $11.5 million. Their capital loss from the foreclosure sale therefore was the amount by which their $11.5 million adjusted basis in the properties exceeded their $7.2 million amount realized, or $4.3 million. Because they had held both properties for more than one year, the loss was a long-term capital loss.

- *Anti-deficiency statutes must be considered.* As the Tax Court pointed out in *Breland*, if the debt secured by foreclosed properties is nonrecourse debt, then the taxpayers' amount realized from the foreclosure sale generally will be the full amount of the nonrecourse debt. In determining whether debt is nonrecourse, it is necessary to consider so-called state anti-deficiency statutes, which prohibit lenders from holding borrowers responsible for the difference between the amount of the mortgage loan secured by the property and the price for which the property is sold at the foreclosure sale. If a state anti-deficiency law applies, then the debt will be treated as nonrecourse debt and the taxpayers' amount realized from the foreclosure sale generally will be the full amount of the debt. For an example of a case reaching this result, see *Simonsen v. Commissioner*, 150 T.C. No. 8 (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.

B. Interest, Dividends, and Other Current Income

C. Profit-Seeking Individual Deductions

1. The IRS gets hoisted by its own petard, and in the process, we get an unusual lesson in "following the money" for purposes of the interest expense deduction limits under IRC § 163. Lipnick v. Commissioner, 153 T.C. No. 1 (8/28/19). Although the facts are a bit convoluted, this Tax Court opinion by Judge Lauber reaffirms the "follow the money" principles for determining deductible interest expense under IRC § 163, including for debt-financed partnership distributions and the aftermath thereof. The taxpayer's father held membership interests in several limited liability companies ("LLCs") classified as partnerships for federal income tax purposes. The LLCs owned and managed very profitable residential rental properties in the Washington, D.C., area. In 2009—*really??? . . . during the great recession??? . . . wow!*—the LLCs made nonrecourse debt-financed

distributions to the taxpayer's father totaling approximately $80 million. The taxpayer's father used the proceeds of these debt-financed distributions to purchase investment assets that he held personally. Similarly, in 2012, the taxpayer's father received, directly and indirectly, yet another debt-financed distribution of approximately $1.7 million from a residential rental property limited partnership ("LP") in which he and his family limited partnership ("FLP") were partners. The taxpayer's father also used the proceeds of this debt-financed distribution to purchase investment assets that he held personally. For the years 2009-2012, pursuant to Notice 89-35, 1989-1 C.B. 675, and Temp. Reg. § 1.163-8T(a)(4)(i)(C), the taxpayer's father reported his allocable share of the LLCs' and the LP's interest expense (including the LP's interest expense passed through his FLP) as investment interest for purposes of the IRC § 163(d)(1) limitation on the deductibility of investment interest. (Incidentally, it appears that the taxpayer's father was able to deduct his entire allocable share of the LLCs' and LP's interest expense during the years 2009-2012 because the taxpayer's father had ample investment income during those years.) Midway through 2011, the taxpayer's father gave a portion of his membership interests in the LLCs to his taxpayer-son. Then, in October of 2012, the taxpayer's father died bequeathing his partnership interests in the LP and FLP to his taxpayer-son. The foregoing transfers from the father to the taxpayer-son were treated as part-gift/part-sale transactions because the father's allocable share of the LLCs' and LP's debt (including debt allocated via the FLP) was treated as an amount realized by the father, and an amount paid by the taxpayer-son, under Reg. § 1.752-1(h) and § 1.1001-2(a)(4)(v). In fact, the taxpayer's father had reported taxable capital gains of approximately $23 million from his "gift" of the LLC interests to his taxpayer-son in 2011. (Presumably, no capital gains were realized or recognized upon the taxpayer father's bequest of the LP and FLP interests to his taxpayer-son in 2012 due to the estate's stepped-up basis.) After receiving the foregoing LLC, LP, and FLP interests, the taxpayer-son did not continue to report his allocable share of the LLCs' and LP's interest expense as investment interest. Rather, the taxpayer-son reported his allocable share of the LLCs' and LP's interest expense for the years 2012 and 2013 as properly allocable to the underlying real estate assets and rental income of the LLCs and the LP. Accordingly, the taxpayer-son deducted his allocable shares of the interest expense against his allocable shares of the rental income. The IRS, noticing the change in treatment of the interest, audited the taxpayer-son (because the LLCs and the LP were not subject to TEFRA-partnership audit rules), disallowed the deduction of the interest expense against the rental income of the LLCs and the LP, and proposed deficiencies for 2012 and 2013 totaling approximately $500,000. (Presumably, unlike his father, the taxpayer-son did not have sufficient investment income to be able to fully deduct his allocable share of the interest expense from the LLCs and LP.)

In support of his position that the interest expense was properly allocable to and deductible against the rental income of the LLCs and the LP (including debt allocated via the FLP), the taxpayer-son relied upon Reg. § 1.752-1(h) and § 1.1001-2(a)(4)(v) cited above as well as the regulations under § 163. Specifically, Temp. Reg. § 1.163-8T(c)(3)(ii)(C) provides that if a taxpayer "takes property subject to debt," and no debt proceeds are disbursed to the taxpayer, the debt is treated as being used to acquire the property. Accordingly, the associated interest expense is allocated to the acquired property for purposes of the deduction limitations of § 163. The taxpayer-son contended that even though his LLC interests were received via "gift," and the LP interest was received via a bequest, the taxpayer-son was allocated a share of LLCs' and the LP's debt, and he thus acquired his interests "subject to debt." Further, the taxpayer-son relied upon Notice 89-35, 1989-1 C.B. 675, which provides in relevant part that "in the case of debt proceeds allocated under [Reg. 1.163-8T] to the purchase of an interest in a passthrough entity (other than by way of a contribution to the capital of the entity), the debt proceeds and the associated interest expense shall be allocated among all of the assets of the entity using any reasonable method." The IRS argued that taxpayer-son was bound by the father's treatment of the interest as an investment expense because a "once investment interest, always investment interest" rule should apply. Moreover, the IRS argued that Temp. Reg. § 1.163-8T(c)(3)(ii)(C) was not relevant because the taxpayer-son did not actually "take [his LLC and LP interests] subject to a debt" as contemplated by the regulations and Notice 89-35; but rather, the rules of Reg. § 1.752-1(h) and § 1.1001-2(a)(4)(v) use such an approach for purposes of subchapter K, not § 163. The Tax Court (Judge Lauber) disagreed with the IRS, citing Temp. Reg. § 1.163-8T(c)(3)(ii)(C) and Notice 89-35,

1989-1 C.B. 675, as noted above. Judge Lauber determined that the IRS's position had no authoritative support and that the taxpayer-son's position was correct. Judge Lauber wrote, "In short, whereas [the taxpayer's father] received a debt-financed distribution, the [taxpayer-son] is treated as having made a debt-financed acquisition of the partnership interests he acquired from [his father]." Therefore, reasoned Judge Lauber, the IRS's own Notice 89-35, 1989-1 C.B. 675, expressly allows the interest expense to be allocated to the real estate assets and income generated by the LLCs and LP (as was done by the taxpayer-son).

D. Section 121

E. Section 1031

F. Section 1033

G. Section 1035

H. Miscellaneous

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. Ministers pray this "crabby" case gets reversed (again!) on appeal. Gaylor v. Mnuchin, 278 F.Supp.3d 1081 (W.D. Wis. 10/6/17). In a case that previously was overturned on appeal to the Seventh Circuit, the U.S. District Court for the Western District of Wisconsin (Judge Crabb) held that § 107(2) is unconstitutional because it violates the First Amendment's establishment clause. Section 107(2) excludes from gross income a "rental allowance" paid to a minister as part of his or her compensation. Section 107(1) excludes the "rental value of a home" furnished to a minister as part of his or her compensation. For technical reasons, only § 107(2)'s "rental allowance" exclusion was at issue in this case. The named plaintiff, Gaylor, is co-president of the true plaintiff, Freedom from Religion Foundation, Inc. ("FFRF"). In a prior iteration of the case, *Freedom from Religion Foundation, Inc. v. Lew*, 773 F.2d 815 (7th Cir. 2014), the Seventh Circuit vacated Judge Crabb's prior ruling striking down § 107(2) by determining that FFRF lacked standing to sue; however, the Seventh Circuit essentially instructed FFRF on how it might obtain standing. FFRF dutifully followed the Seventh Circuit's directions and then refiled its claim with Judge Crabb that § 107(2) violates the First Amendment's establishment clause. FFRF argued that § 107(2) violates the establishment clause because it "demonstrates a preference for ministers over secular employees." Judge Crabb agreed and ruled that § 107(2) is unconstitutional and ordered the IRS to cease enforcing the statute. In a subsequent decision, though, Judge Crabb ordered that the court's injunction prohibiting enforcement of the statute be stayed until 180 days after resolution of any appeal. *See Gaylor v. Mnuchin*, 2017 U.S. Dist. LEXIS 209746, 2017 WL 6375819 (12/13/17). In other words, stay tuned . . . .

a. Prayers answered! Gaylor v. Mnuchin, 919 F.3d 420 (7th Cir. 3/15/19), *rev'g* 278 F.Supp.3d 1081 (W.D. Wis. 10/6/17). On appeal, the Seventh Circuit reversed and upheld the constitutionality of § 107(2). Treasury and the IRS argued before the Seventh Circuit that although § 107(2) seems to advance a religious purpose by excluding rental allowances paid to "ministers of the gospel," the history of § 107(2) reveals a secular purpose. To wit, Congress enacted § 107 in 1923 as a response to the IRS's original position in 1921 that the "convenience of the employer" exception for employer-providing housing (now codified at § 119(a)(2)) did not apply to ministers. Treasury and IRS argued that § 107(2) was merely an extension of the "convenience of the employer" exception to gross income, not an impermissible government "establishment" of a religious preference. Writing for the court, Judge Brennan agreed, stating:

> Reading § 107(2) in isolation from the other convenience-of-the-employer provisions, and then highlighting the term "minister," could make the challenged statute appear to provide a government benefit exclusively to the religious. But reading it in context, as we must, we see § 107(2) is simply one of many per se rules that provide a tax exemption to employees with work-related housing requirements.

Moreover, Judge Brennan explained that although § 107(2) has broader application than the "convenience of the employer" exception of § 119(a)(2), the breadth of § 107(2) does not render the statute unconstitutional. In fact, Judge Brennan reasoned that § 107(2) is broadly written to avoid excessive government entanglement with the internal operations of a church. Otherwise, without § 107(2), § 119(a)(2) would require the IRS to interrogate ministers as to the use of their homes for religious purposes. Further, § 119(a)(2) would require the IRS to determine the scope of the "business" of the church and where and how far the "premises" of the church extend. As written, § 107(2) avoids such excessive entanglement of government into the affairs of the church. Similarly, the court determined that § 107(2) does not unconstitutionally "advance" religion over secular purposes because providing a tax exemption does not "connote[] sponsorship, financial support, and active involvement of the [government] in religious activity." Finally, the court ruled that § 107(2) passes the "historical significance" test under the establishment clause because tax exemptions have been provided to religious and religious-affiliated organizations by Congress almost since the Sixteenth Amendment authorized the federal income tax in 1913.

2. IRS Chief Counsel says that an individual who is a 2-percent S corporation shareholder pursuant to the § 318 constructive ownership rules is entitled to a deduction under § 162(l) for amounts paid by the S corporation under a group health plan for all employees and included in the individual's gross income if the individual otherwise meets the requirements of § 162(l). CCA 201912001, 2019 WL 1573655 (12/21/18, released 3/22/19). In this Chief Counsel Advice, the IRS Office of Chief Counsel concluded that an individual who was treated as a 2-percent S corporation shareholder because the stock of a family member was attributed to the individual under the constructive ownership rules of § 318 could deduct the amounts paid by the S corporation under a group health plan and included in the individual's gross income.

Background. Under § 1372(a), an S corporation is treated as a partnership and a 2-percent shareholder of an S corporation is treated as a partner for purposes of applying the provisions of the Code relating to employee fringe benefits. For this purpose, a 2-percent shareholder is any person who owns (or is considered to own under the constructive ownership rules of § 318) on any day during the S corporation's tax year more than 2 percent of the corporation's outstanding stock or stock possessing more than 2 percent of the total combined voting power of all stock of the corporation. According to Rev. Rul. 91-26, 1991-1 C.B. 184, accident and health insurance premiums paid by an S corporation on behalf of a 2-percent shareholder-employee as compensation for services are treated like guaranteed payments to partners under § 707(c). Therefore, the S corporation can deduct the premiums and the 2-percent shareholder-employee must include an appropriate portion of the premiums in gross income. The S corporation must report the premiums on the 2-percent shareholder-employee's Form W-2, but according to IRS Announcement 92-16, such amounts are not wages subject to Social Security and Medicare taxes if the requirements of the exclusion in § 3121(a)(2)(B) are met. Section 162(*l*) authorizes an above-the-line deduction for a taxpayer who is an employee within the meaning of § 401(c)(1) for an amount equal to the amount paid during the year for insurance that constitutes medical care for the taxpayer and the taxpayer's spouse, dependents, and children who have not attained the age of 27. This deduction is available to a 2-percent shareholder-employee of an S corporation if the plan is established by the S corporation. Guidance on when the plan is considered established by the S corporation is provided in Notice 2008-1, 2008-2 I.R.B. 251. The deduction is limited to the taxpayer's earned income from the trade or business with respect to which the plan providing medical care is established and is not available if the taxpayer is eligible to participate in a subsidized health plan maintained by an employer of the taxpayer or of the taxpayer's spouse or dependents.

Facts. An individual owned 100% of an S corporation, which employed the individual's family member. Because of the family relationship, the family member was considered to be a 2-percent shareholder pursuant to the attribution of ownership rules under § 318. The S corporation provided a group health plan for all employees, and the amounts paid by the S corporation under the group health plan were included in the family member's gross income. Chief Counsel was asked whether an individual who was a 2-percent shareholder of an S corporation pursuant to the constructive ownership

rules of § 318 by virtue of being a family member of the S corporation's sole shareholder was entitled to the deduction under § 162(*l*) for amounts that were paid by the S corporation under a group health plan for all employees and included in the individual's gross income.

Chief Counsel's Conclusion. Chief Counsel concluded that "an individual who is a 2-percent shareholder of an S corporation pursuant to the attribution of ownership rules under §318 is entitled to the deduction under § 162(*l*) for amounts that are paid by the S corporation under a group health plan for all employees and included in the individual's gross income if the individual otherwise meets the requirements of section 162(*l*)."

B. Qualified Deferred Compensation Plans

1. They were just kidding! Treasury and the IRS no longer plan to amend the regulations under § 401(a)(9) to prohibit giving retirees receiving annuity payments the option to receive a lump-sum payment. Notice 2019-18, 2019-13 I.R.B. 915 (3/6/19). A number of sponsors of defined benefit plans have amended their plans to provide a limited period during which certain retirees who are currently receiving lifetime annuity payments from those plans may elect to convert their annuities into lump sums that are payable immediately. These arrangements are sometimes referred to as retiree lump-sum windows. In Notice 2015-49, 2015-30 I.R.B. 79 (7/9/15), the IRS announced that Treasury and the IRS planned to amend the required minimum distribution regulations under § 401(a)(9) to provide that qualified defined benefit plans generally are not permitted to replace any joint and survivor, single life, or other annuity currently being paid with a lump-sum payment or other accelerated form of distribution. With certain exceptions, the amendments to the regulations were to apply as of July 9, 2015. Notice 2019-18 provides that Treasury and the IRS no longer intend to propose the amendments to the regulations under § 401(a)(9) that were described in Notice 2015-49. The notice indicates that Treasury and the IRS will continue to study the issue of retiree lump-sum windows. The notice further provides:

> Until further guidance is issued, the IRS will not assert that a plan amendment providing for a retiree lump-sum window program causes the plan to violate § 401(a)(9), but will continue to evaluate whether the plan, as amended, satisfies the requirements of §§ 401(a)(4), 411, 415, 417, 436, and other sections of the Code. During this period, the IRS will not issue private letter rulings with regard to retiree lump-sum windows. However, if a taxpayer is eligible to apply for and receive a determination letter, the IRS will no longer include a caveat expressing no opinion regarding the tax consequences of such a window in the letter.

2. Some inflation-adjusted numbers for 2020. Notice 2019-59, 2019-47 I.R.B. 1091 (11/8/19).

- Elective deferrals in §§ 401(k), 403(b), and 457 plans are increased from $19,000 to $19,500 with a catch-up provision for employees aged 50 or older that is increased from $6,000 to $6,500.

- The limit on contributions to an IRA remains unchanged at $6,000. The AGI phase-out range for contributions to a traditional IRA by employees covered by a workplace retirement plan is increased to $65,000 to $75,000 (from $64,000-$74,000) for single filers and heads of household, increased to $104,000-$124,000 (from $103,000-$123,000) for married couples filing jointly in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, and increased to $189,000-$199,000 (from $193,000-$203,000) for an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered. The phase-out range for contributions to a Roth IRA is increased to $196,000-$206,000 (from $193,000-$203,000) for married couples filing jointly, and increased to $124,000-$139,000 (from $122,000-$137,000) for singles and heads of household.

- The annual benefit from a defined benefit plan under § 415 is increased to $230,000 (from $225,000).

- The limit for defined contribution plans is increased to $57,000 (from $56,000).

- The amount of compensation that may be taken into account for various plans is increased to $285,000 (from $280,000), and is increased to $425,000 (from $415,000) for government plans.

- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to $65,000 (from $64,000) for married couples filing jointly, increased to $48,750 (from $48,000) for heads of household, and increased to $32,500 (from $32,000) for singles and married individuals filing separately.

3. The cap on elective deferrals to § 401(k) plans pursuant to automatic contribtuion arrangements is now 15 percent. A provision of the SECURE Act, Division O, Title 1, § 102 of the 2020 Further Consolidated Appropriations Act, amended Code § 401(k)(13)(C)(iii) to increase from 10 percent to 15 percent the cap on elective deferrals to a § 401(k) plan under an automatic contribution arrangement. An automatic contribution arrangement allows an employer automatically to deduct elective deferrals from an employee's wages unless the employee makes an election not to contribute or to contribute a different amount. This change applies to plan years beginning after December 31, 2019.

4. Congress has increased the age at which RMDs must begin to 72. 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 required minimum distributions (RMDs) from a qualified plan (including IRAs) must begin from 70-½ to 72. Pursuant to this amendment, RMDs must begin by April 1 of the calendar year following the later of the calendar year in which the employee attains age 72 or, in the case of an employer plan, the calendar year in which the employee retires. This latter portion of the rule allowing deferral of RMDs from employer plans until retirement does not apply to a 5-percent owner (as defined in § 416). The increase in the age at which RMDs must begin until age 72 applies to distributions required to be made after December 31, 2019, with respect to individuals who attain age 70-½ after such date.

5. No more stretching out RMDs from non-spousal inherited qualified retirement accounts. A provision of the SECURE Act, Division O, Title IV, § 401 of the 2020 Further Consolidated Appropriations Act amended Code § 401(a)(9)(E) to modify the required minimum distribution (RMD) rules for inherited retirement accounts (defined contribution plans and IRAs). The amendments require all funds to be distributed by the end of the 10th calendar year following the year of death. There is no requirement to withdraw any minimum amount before that date. The current rules, which permit taking RMDs over many years, continue to apply to a designated beneficiary who is (1) a surviving spouse, (2) a child of the participant who has not reached the age of majority, (3) disabled within the meaning of § 72(m)(7), (4) a chronically ill individual within the meaning of § 7702B(c)(2) with some modifications, or (5) an individual not in any of the preceding categories who is not more than 10 years younger than the deceased individual These changes generally apply to distributions with respect to those who who die after December 31, 2019.

6. Penalty-free withdrawals for birth or adoption. A provision of the SECURE Act, Division O, Title I, § 113 of the 2020 Further Consolidated Appropriations Act, amended Code § 72(t)(2) to add new § 72(t)(2)(H), which provides for penalty-free withdrawals from "applicable eligible retirement plans" for a "qualified birth or adoption distribution." A "qualified birth or adoption distribution" is defined as "any distribution from an applicable eligible retirement plan to an individual if made during the 1-year period beginning on the date on which a child of the individual is born or on which the legal adoption by the individual of an eligible adoptee is finalized." A distribution can be treated as qualifying only if the taxpayer includes the name, age, and taxpayer identification number of the child on the taxpayer's tax return for the taxable year. The maximum penalty-free distribution is $5,000 per individual per birth or adoption. This change applies to distributions made after Dec. 31, 2019.

7. Congress has made access to retirement plan funds easier for survivors of certain natural disasters. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title II, § 202 of the 2020 Further Consolidated Appropriations Act, provides special rules that apply to distributions from qualified employer plans and IRAs and to loans from qualified employer plans for survivors of certain natural disasters.

Qualified Disaster Distributions. Section 202(a) of the legislation provides four special rules for "qualified disaster distributions." **First**, the legislation provides that qualified disaster distributions up to an aggregate amount of $100,000 for each qualified disaster 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 qualified disaster distribution is reported ratably over the three-year period beginning with the year of the distribution. **Third**, the legislation permits the recipient of a qualified disaster 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**, qualified disaster 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 *qualified disaster 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) before June 17, 2020 (the date that is 180 days after December 20, 2019, the date of enactment of the legislation), (2) on or after the first day of the incident period of a qualified disaster, and (3) to an individual whose principal place of abode at any time during the incident period of the qualified disaster was located in the qualified disaster area of that qualified disaster and who sustained an economic loss by reason of that qualified disaster.

Recontributions of Withdrawals Made for Home Purchases. Section 202(b) of the legislation permits an individual who received a "qualified 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. A qualified distribution is a hardship distribution that an individual received from a qualified employer plan or IRA during the period that is 180 days before the first day of the incident period of the relevant qualified disaster and ending on the date that is 30 days after the last day of the incident period that was to be used to purchase or construct a principal residence in a qualified disaster area that was not purchased or constructed on account of the qualified disaster. The contribution need not be made to the same plan from which the distribution was received, and must be made during the "applicable period," which is the period beginning on the first day of the incident period of the qualified disaster and ending on the date that is 30 days after the last day of the incident 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.

Loans. For qualified individuals, section 202(c) 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 December 20, 2019 (the date of enactment) through June 16, 2020

(the 180-day period beginning on the date of enactment), 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 the first day of the incident period of a qualified disaster with a due date for any repayment occurring during the period beginning on the first day of the incident period and ending on the date which is 180 days after the last day of the incident period, 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 whose principal place of abode at any time during the incident period of a qualified disaster is located in the qualified disaster area with respect to that qualified disaster and who sustained an economic loss by reason of the qualified disaster.

Defined Terms. Several key terms are defined in Division Q, Title II, § 201 of the 2020 Further Consolidated Appropriations Act. These are as follows:

1. The term "*incident period*" with respect to any qualified disaster is the period specified by FEMA as the period during which the disaster occurred, except that the period cannot be treated as beginning before January 1, 2018, or ending after January 19, 2020 (the date that is 30 days after the date of enactment of the legislation).
2. The term "*qualified disaster zone*" is the portion of the qualified disaster area determined by the President to warrant individual or individual and public assistance from the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of the qualified disaster with respect to the qualified disaster area.
3. The term "*qualified disaster area*" is an area with respect to which the President declared a major disaster from January 1, 2018, through February 18, 2020 (the date that is 60 days the date of enactment of the legislation), under section 401 of the Stafford Act if the incident period of the disaster began on or before December 20, 2019 (the date of enactment). To avoid providing double benefits, the legislation excludes the California wildfire disaster area, for which similar relief was provided by the Bipartisan Budget Act of 2018.
4. "The term '*qualified disaster*' means, with respect to any qualified disaster area, the disaster by reason of which a major disaster was declared with respect to such area."

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

D. Individual Retirement Accounts

1. A rollover that was deposited 62 days after withdrawal from an IRA was not taxable because it constituted a bookkeeping error and qualified for a hardship waiver. Burack v. Commissioner, T.C. Memo. 2019-83 (7/9/19). The taxpayer withdrew $524,981 from her IRA to purchase a home while waiting for her former home to sell. She planned to redeposit the funds in her IRA within the 60-day period permitted by § 408(d)(3)(A) for making a tax-free rollover of IRA funds. Pershing, LLC served as custodian of the IRA. The taxpayer's financial adviser was a representative of Capital Guardian, LLC. The relationship between Pershing and Capital Guardian was not entirely clear. Capital Guardian generated statements for the taxpayers IRA and the statements listed both Pershing and Capital Guardian. Pursuant to instructions from Capital Guardian, on Thursday, August 21, 2014, 57 days after the taxpayer's withdrawal, the taxpayer sent a check for $524,981 by overnight delivery to Capital Guardian, which received the check the next day. For reasons that are not clear, the check was not deposited at Pershing in the taxpayer's IRA until Tuesday, August 26, 2014, which was 62 days after the taxpayer's withdrawal. The IRS issued a notice of deficiency in which the IRS asserted that the taxpayer had to include the withdrawn funds in gross income because the taxpayer had not rolled them over within the required 60-day period. The Tax Court (Judge Ruwe) held that the taxpayer was entitled to treat the transaction as a tax-free rollover for two reasons. *First*, the court concluded that the withdrawn funds were not redeposited in a timely manner because of a bookkeeping

error by Capital Guardian. "Because the check was received by Capital Guardian during the rollover period but not book-entered by Capital Guardian until after, we find that the late recording is due to a bookkeeping error." The court reasoned that the situation was analogous to that in *Wood v. Commissioner*, 93 T.C. 114 (1989), in which the court reached a similar conclusion when the taxpayer had transferred stock to Merrill Lynch within the 60-day period with instructions that it be deposited in the taxpayer's IRA, but Merrill Lynch deposited the stock in a nonqualified account before transferring it to the IRA after the 60-day period. *Second*, the court held that the taxpayer was eligible for a hardship waiver under § 408(d)(3)(I). As interpreted by Rev. Proc. 2003-16, 2003-1 C.B. 359, an automatic waiver under § 408(d)(3)(I) is granted if, prior to the expiration of the 60-day period, a financial institution receives funds on behalf of a taxpayer, the taxpayer follows all procedures required by the financial institution for depositing the funds into an eligible retirement plan (including giving instructions for deposit of the funds) and, "solely due to an error on the part of the financial institution, the funds are not deposited into an eligible retirement plan within the 60-day rollover period," if two conditions are satisfied: (1) the funds are deposited into an eligible retirement plan within 1 year from the beginning of the 60-day rollover period; and (2) if the financial institution had deposited the funds as instructed, it would have been a valid rollover. The court concluded that all requirements for an automatic hardship waiver were satisfied and that this served as an alternative basis for treating the taxpayer's withdrawal and contribution as a tax-free rollover.

2. Amounts paid to an individual to aid in the pursuit of graduate or postdoctoral study and included in the individual's gross income are now treated as compensation for purposes of contributing to an IRA. A provision of the SECURE Act, Division O, Title 1, § 106 of the 2020 Further Consolidated Appropriations Act, amended Code § 219(f)(1) to provide that amounts paid to an individual to aid in the pursuit of graduate or postdoctoral study and included in the individual's gross income are now treated as compensation for purposes of the limit on contributing to an IRA. Such amounts would include taxable stipends and non-tuition fellowship payments received by graduate and postdoctoral students. This change applies to taxable years beginning after December 31, 2019.

3. ♪♫I don't know, but I've been told, if you [contribute to an IRA] you'll never grow old.♫♪ Congress has eliminated the age restriction for contributions to traditional IRAs. A provision of the SECURE Act, Division O, Title I, § 107 of the 2020 Further Consolidated Appropriations Act, repealed former Code § 219(d)(1). The effect of this change is to eliminate the age restriction (age 70-½) for contributions to traditional IRAs. The legislation also amends § 408(d)(8)(A), which allows taxpayers who are age 70-½ or older to make tax-free distributions to a charity from an IRA of up to $100,000 per year, to reduce a taxpayer's ability to make such tax-free contributions to a charity from an IRA by the amount of withdrawals taken after age 70-½. The reduction in the $100,000 annual limit under § 408(d)(8)(A) is the amount by which the taxpayer's aggregate deductible contributions to an IRA made after age 70-½ exceed the aggregate reductions of the $100,000 limit in all prior taxable years. These changes apply to contributions and distributions made for taxable years beginning after December 31, 2019.

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

1. Who would have thought that selling your life insurance policy to a stranger was a good idea anyway? Notice 2018-41, 2018-20 I.R.B. 584 (4/26/18) The 2017 Tax Cuts and Jobs Act, §§ 13520-13522, has modified the rules concerning the exclusion of life insurance proceeds upon the death of the insured as well as the determination of basis in a life insurance contract. The modified rules primarily impact the tax treatment of so-called life settlements (where a stranger purchases a life insurance policy on a healthy insured) and viatical settlements (where a stranger purchases a life insurance policy on a terminally-ill insured). Particularly, as explained in detail below, amended § 101 now contains a special carve-out to the normal life insurance policy transfer-for-value rules. *See*

§ 101(a)(3). This special carve-out applies to "reportable policy sales," which generally will include life settlement and viatical settlement transactions. Furthermore, § 13520 adds new § 6050Y to impose unique reporting requirements on the transferor and the insurer with respect to "reportable policy sales." In part, new § 6050Y will require disclosure of "reportable death benefits," as defined, but essentially meaning death benefits paid on an insurance policy that has been transferred in a "reportable policy sale." Finally, § 13521 adds 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 for mortality expenses or other reasonable charges incurred under the contract (also known as ''cost of insurance''). Notice 2018-41 states that the IRS will issue proposed regulations providing guidance concerning the new rules and that otherwise required reporting under § 6050Y will be delayed until after final regulations are published. We commend Notice 2018-41 for careful study by those readers advising clients on life settlement and viatical settlement transactions. The changes made by TCJA to § 101 and the addition of § 6050Y (which are the focus of the Notice) apply to taxable years beginning after 2017. The amendment adding new § 1016(a)(1)(B) applies retroactively to transactions entered into after August 25, 2009. For additional background, see below.

Some background. Section 101 generally excludes from gross income the proceeds of a life insurance policy payable by reason of the death of the insured. If, however, a life insurance policy is transferred for valuable consideration prior to the death of the insured (i.e., "a transfer for value"), then death benefit proceeds (to the extent they exceed the transferee-owner's basis in the policy) are includable in gross income by the transferee-owner of the policy upon the insured's death *unless an exception applies*. These exceptions provide that, notwithstanding a transfer for value, death benefit proceeds remain excludable if (i) the transferee-owner's basis in the policy is determined in whole or in part by reference to the transferor's basis (e.g., a carryover basis transaction) or (ii) the transferee-owner is the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation of which the insured is a shareholder or officer. If a transfer-for-value exception does not apply, then Rev. Rul. 2009-14, 2009-1 C.B. 1031 (5/2/09) sets out the IRS's position that any death benefit payable to the transferee-owner is ordinary income (to the extent it exceeds the transferee-owner's basis in the policy) while a subsequent sale of the policy by the transferee-owner before the death of the insured can produce capital gain.

Why new rules? Life settlement and viatical settlement transactions have increased over the last several years. The increase in the estate and gift tax exemption has contributed in part to this market because some previously purchased life insurance policies are no longer to pay anticipated estate taxes. Changes to restrictive state laws concerning so-called "stranger-owned" life insurance also have contributed to an increase in these transactions. In a typical *life settlement* transaction, the policyholder, often the individual insured under the life insurance contract, sells his or her life insurance contract to an unrelated person. The consideration paid generally is a lump-sum cash payment that is less than the death benefit on the policy, but more than the amount that would be received by the policyholder upon surrender of the life insurance contract. The IRS previously announced its position regarding the tax treatment of life settlement transactions in Rev. Rul. 2009-13, 2009-1 C.B. 1029 (05/01/09). Oversimplifying somewhat, Revenue Ruling 2009-13 provides that the seller of a policy in a life settlement transaction recognizes capital gain except with respect to the "inside buildup" in the policy (e.g., growth in cash surrender value of whole life insurance) over prior premium payments. This latter amount attributable to the inside buildup in the policy is characterized as ordinary income. The IRS also took the position in Rev. Rul. 2009-13 that the seller's basis in a transferred policy must be adjusted downward by the cost of insurance separate from the investment in the contract. As discussed above, TCJA's addition of new § 1016(a)(1)(B) reverses the IRS's position in this regard. A *viatical settlement*, a special type of life settlement transaction, may involve the sale of a life insurance contract by the owner, but under § 101(g) may not necessarily be taxed like a life settlement transaction. Under a viatical settlement, a policyholder may sell or assign a life insurance contract after the insured has become terminally ill or chronically ill. If any portion of the death benefit under a life insurance contract on the life of an insured who is terminally ill or chronically ill (within the meaning of § 101(g))

is sold (through the sale of the life insurance contract) or assigned in a viatical settlement to a "viatical settlement provider" (as defined), the amount paid for the sale or assignment of that portion is treated as an amount paid under the life insurance contract by reason of the death of the insured (which may be excludable under § 101), rather than gain from the sale or assignment (which generally would not be excludable under § 101 unless a transfer-for-value exception applied). A viatical settlement provider for purposes of these rules is a person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts insuring the lives of terminally ill or chronically ill individuals (provided certain requirements are met). *See* Rev. Rul. 2002-82, 2002-2 C.B. 978 (12.23/02).

So, what's in the new rules? Under new § 101(a)(3), the longstanding transfer-for-value exceptions described above do not apply if the transfer of the life insurance policy is a "reportable policy sale." A reportable policy sale is defined as "the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract." Pursuant to § 101(a)(3)(B), the term "indirectly" as used in this context applies to the acquisition of an interest in a life insurance contract via a partnership, trust, or other entity. Beyond the above statutory language, however, new § 101(a)(3) provides no further guidance as to specifics, such as the "substantial family, business, or financial relationships" (including ownership via partnerships, trusts, or other entities) that exempt an otherwise reportable policy sale from the special inclusion rule of new § 101(a)(3). In effect, then, Notice 2018-41 is the IRS's means of telling insurers and those engaged in life settlement and viatical settlement transactions that the IRS knows the statutes are unclear and that the necessary guidance to comply with the new rules is forthcoming.

a. Proposed regulations provide guidance on information reporting obligations under § 6050Y related to reportable policy sales of life insurance contracts and payments of reportable death benefits. REG-103083-18, Information Reporting for Certain Life Insurance Contract Transactions and Modifications to the Transfer for Valuable Consideration Rules, 84 F.R. 11009 (3/25/19). The Treasury Department and the IRS have issued proposed regulations that provide guidance on the information reporting obligations created by § 6050Y related to reportable policy sales of life insurance contracts and payments of reportable death benefits. Section 6050Y was enacted as part of the 2017 Tax Cuts and Jobs Act. The proposed regulations also provide guidance on the amount of death benefits excluded from gross income under § 101 following a reportable policy sale. Certain provisions of the proposed regulations are proposed to apply to reportable policy sales made and reportable death benefits paid after December 31, 2017. Transition rules apply to reportable policy sales made and reportable death benefits paid before the date on which final regulations are published in the Federal Register. Other provisions of the proposed regulations are proposed to apply on and after the date final regulations are published in the Federal Register.

2. "I think, therefore I am." The taxpayer argued that body and mind are inseparable, but the Tax Court gave effect to Internal Revenue Code's dualist view of body and mind and held that the damages received by the taxpayer were for emotional distress and therefore included in gross income. Doyle v. Commissioner, T.C. Memo. 2019-8 (2/6/19). The taxpayer was employed by a corporation in the technology sector but was fired after he brought to the Chief Executive Officer his concerns about the company's anticompetitive behavior. Following his termination, the taxpayer couldn't sleep, couldn't digest food properly, and had lots of other health problems. He struggled with chronic headaches, he couldn't concentrate, and he had neck, shoulder, and back pain. His relationship with his wife suffered, and he believes that he'll deal with some of these issues for the rest of his life.

The Tax Court (Judge Holmes) found that the taxpayer's ailments were the consequence of emotional distress he suffered when he was fired. The taxpayer and his former employer entered into a settlement agreement that provided for payment of $350,000 of "alleged unpaid wages," which his employer reported on Form W-2, and also provided for payment of $250,000 "for his alleged emotional distress damages," which his employer reported on Form 1099-MISC. His former employer paid the

$250,000 in two equal installments in 2010 and 2011. The taxpayer's CPA, who had more than forty years' experience preparing tax returns, concluded that the $250,000 reported on Forms 1099-MISC were excluded from the taxpayer's gross income under § 104(a)(2), which excludes from gross income the amount of any damages received on account of personal physical injury or physical sickness. The taxpayer's returns for 2010 and 2011 each included a Schedule C on which the taxpayer reported income of $125,000, deducted some legal fees, and also deducted an amount for "personal injury" (2010) or "pain and suffering" (2011) in an amount sufficient to zero out the income on Schedule C. The taxpayer also deducted some legal fees for 2010 on Schedule A. The Tax Court held that the $250,000 received by the taxpayer was includible in the taxpayer's gross income pursuant to the language of § 104(a), which provides that "emotional distress shall not be treated as a physical injury or physical sickness." In reaching this conclusion, the court relied on both its prior decisions (such as *Pettit v. Commissioner*, T.C. Memo. 2008-87) and the legislative history of the 1996 amendments to § 104(a), both of which establish that, for purposes of § 104(a), "emotional distress" includes physical symptoms that result from emotional distress, such as insomnia, headaches, and stomach disorders. The court rejected the taxpayer's argument that his job termination caused stress, and that "one can't really distinguish symptoms of emotional distress from symptoms of other physical injuries or sicknesses because '[p]hysical relates to both the body and mind which are inseparable in a person.'" The court concluded that the taxpayer "may well be right ontologically, but not legally." The court also disallowed the deduction of legal fees on Schedule C (but not on Schedule A because the IRS had not challenged those) and declined to impose accuracy-related penalties under § 6662(a) because the taxpayer had relied in good faith on the advice of his CPA and also because the IRS had not introduced any evidence that the penalties had been "personally approved (in writing) by the immediate supervisor of the individual making [the initial] determination" of the penalty as required by § 6751(b)(1).

Tax treatment of the amounts received by the taxpayer for unpaid wages. There apparently was no dispute between the parties that the taxpayer had to include in gross income the $350,000 of "alleged unpaid wages" that his former employer paid and reported on Form W-2 because the court did not separately discuss it. If the taxpayer had suffered a physical injury, however, and if his inability to earn the wages was the result of his physical injury, then he should have been able to exclude the unpaid wages from his gross income under § 104(a)(2) because the exclusion applies to all damages that flow from a physical injury.

Taxpayers have prevailed in some cases that are difficult to distinguish. The Tax Court concluded in this case that, if a defendant's conduct causes a taxpayer to have emotional distress, then the taxpayer cannot exclude from gross income under § 104(a)(2) any damages or settlement payments received because emotional distress is not a physical injury. The court further concluded that this rule applies even if a taxpayer suffers physical symptoms of the emotional distress, such as insomnia or stomach disorders. In some cases, however, the line between a physical injury, on the one hand, and physical symptoms of emotional distress, on the other, has not been entirely clear. For example, in *Parkinson v. Commissioner*, T.C. Memo. 2010-142, the Tax Court concluded that a taxpayer who suffered a heart attack as a result of emotional distress he experienced in the workplace had suffered a physical injury. Similarly, in *Domeny v. Commissioner*, T.C. Memo. 2010-9, the Tax Court held that a taxpayer whose workplace stress resulted in a flare-up of her pre-existing multiple sclerosis condition could exclude from her gross income under § 104(a)(2) a settlement payment received from her former employer. The ambiguity in the law concerning this issue suggests that careful attention and research are required if a client receives damages or settlement payments in a context in which the client might have suffered from emotional distress.

Even if a taxpayer suffers only emotional distress, the taxpayer can exclude from gross income an amount of damages received to the extent of medical expenses incurred that were not deducted in prior years. Although the statutory language of § 104(a) is clear that emotional distress is not considered a physical injury, the statutory language also states that this rule does "not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress." For example, in the case discussed above, if the taxpayer had incurred $10,000 in costs for psychological counseling as a result of his

emotional distress, then he could have excluded from gross income $10,000 of the $250,000 in settlement payments received from his former employer provided that he had not deducted any portion of the medical expenses in a prior year. If Daniel had deducted in a prior year $4,000 of the $10,000 in medical expenses incurred, then he could have excluded $6,000 of the $250,000 in settlement payments received from his former employer.

3. Like the Energizer Bunny, the issues surrounding the § 164(b)(6) $10,000 limit on the personal deduction for state and local taxes just keep going . . . and going . . . and going . . . Rev. Rul. 2019-11, 2019-17 I.R.B. 1041 (3/29/19). The tax benefit rule has long required taxpayers to include in gross income amounts deducted in a prior tax year that are recovered in the current tax year; however, under § 111(a), the amount so includible in gross income is limited to the amount deducted that resulted in a reduction of the taxpayer's tax liability for the prior year. In other words, the inclusion in gross income of the amount recovered is limited to the "tax benefit" of the amount previously deducted. See Rev. Rul. 93-75, 1993-2 C.B. 63 (inclusion not required for that portion of a taxpayer's state and local tax refund for which a deduction previously was disallowed under the former 3 percent/80 percent limitation on itemized deductions of § 68(a)). Likewise, if a taxpayer's deduction for personal state and local taxes was limited to $10,000 for a prior year (e.g., 2018) by new § 164(b)(6), then a portion of the taxpayer's personal state and local tax refund received in the current year (e.g., 2019) should be excludable from gross income for the current year under § 111. The question, of course, is determining exactly how much of a taxpayer's personal state and local tax refund is excludable for the current year under § 111, especially where the $12,000 standard deduction might have been used by the taxpayer had he or she paid the proper amount of personal state and local taxes due for the prior year instead of making an overpayment. Rev. Rul. 2019-11 holds that the proper amount includible in gross income in these circumstances under § 111 is the lesser of (1) the difference between the taxpayer's total itemized deductions taken in the prior year and the amount of itemized deductions the taxpayer would have taken in the prior year had the taxpayer paid the proper amount of state and local tax, or (2) the difference between the taxpayer's itemized deductions taken in the prior year and the standard deduction amount for the prior year, if the taxpayer was not precluded from taking the standard deduction in the prior year. The above holding applies to the recovery of any state or local tax, including state or local income tax and state or local real or personal property tax. To assist taxpayers in determining the proper amount excludable from gross income under § 111 with respect to a refund of personal state and local taxes subject to the § 164(b)(6) $10,000 limit for a prior year, Rev. Rul. 2019-11 provides several helpful examples. In each example, it is assumed that the taxpayers are unmarried individuals whose filing status is "single" and who itemized deductions on their federal income tax returns for 2018 in lieu of using their standard deduction of $12,000. It is further assumed that the taxpayers did not pay or accrue the taxes in carrying on a trade or business or an activity described in § 212. Moreover, it is assumed that for 2018 the taxpayers were not subject to alternative minimum tax under § 55 and were not entitled to any credit against income tax. Finally, it is assumed that the taxpayers use the cash receipts and disbursements method of accounting.

- Situation 1 (State income tax refund fully includable).

Facts: Taxpayer A paid local real property taxes of $4,000 and state income taxes of $5,000 in 2018. A's state and local tax deduction was not limited by section 164(b)(6) because it was below $10,000. Including other allowable itemized deductions, A claimed a total of $14,000 in itemized deductions on A's 2018 federal income tax return. In 2019, A received a $1,500 state income tax refund due to A's overpayment of state income taxes in 2018.

Held: In 2019, A received a $1,500 refund of state income taxes paid in 2018. Had A paid only the proper amount of state income tax in 2018, A's state and local tax deduction would have been reduced from $9,000 to $7,500 and as a result, A's itemized deductions would have been reduced from $14,000 to $12,500, a difference of $1,500. A received a tax benefit from the overpayment of $1,500 in state income tax in 2018. Thus, A is required to include the entire $1,500 state income tax refund in A's gross income in 2019.

- Situation 2 (State income tax refund not includable)

Facts: Taxpayer B paid local real property taxes of $5,000 and state income taxes of $7,000 in 2018. Section 164(b)(6) limited B's state and local tax deduction on B's 2018 federal income tax return to $10,000, so B could not deduct $2,000 of the $12,000 state and local taxes paid. Including other allowable itemized deductions, B claimed a total of $15,000 in itemized deductions on B's 2018 federal income tax return. In 2019, B received a $750 state income tax refund due to B's overpayment of state income taxes in 2018.

Held: In 2019, B received a $750 refund of state income taxes paid in 2018. Had B paid only the proper amount of state income tax in 2018, B's state and local tax deduction would have remained the same ($10,000) and B's itemized deductions would have remained the same ($15,000). B received no tax benefit from the overpayment of $750 in state income tax in 2018. Thus, B is not required to include the $750 state income tax refund in B's gross income in 2019.

- *Situation 3 (State income tax refund partially includable)*

Facts: Taxpayer C paid local real property taxes of $5,000 and state income taxes of $6,000 in 2018. Section 164(b)(6) limited C's state and local tax deduction on C's 2018 federal income tax return to $10,000, so C could not deduct $1,000 of the $11,000 state and local taxes paid. Including other allowable itemized deductions, C claimed a total of $15,000 in itemized deductions on C's 2018 federal income tax return. In 2019, C received a $1,500 state income tax refund due to C's overpayment of state income taxes in 2018.

Held: In 2019, C received a $1,500 refund of state income taxes paid in 2018. Had C paid only the proper amount of state income tax in 2018, C's state and local tax deduction would have been reduced from $10,000 to $9,500 and as a result, C's itemized deductions would have been reduced from $15,000 to $14,500, a difference of $500. C received a tax benefit from $500 of the overpayment of state income tax in 2018. Thus, C is required to include $500 of C's state income tax refund in C's gross income in 2019.

- *Situation 4 (Standard deduction)*

Facts: Taxpayer D paid local real property taxes of $4,250 and state income taxes of $6,000 in 2018. Section 164(b)(6) limited D's state and local tax deduction on D's 2018 federal income tax return to $10,000, so D could not deduct $250 of the $10,250 state and local taxes paid. Including other allowable itemized deductions, D claimed a total of $12,500 in itemized deductions on D's 2018 federal income tax return. In 2019, D received a $1,000 state income tax refund due to D's overpayment of state income taxes in 2018.

Held: In 2019, D received a $1,000 refund of state income taxes paid in 2018. Had D paid only the proper amount of state income tax in 2018, D's state and local tax deduction would have been reduced from $10,000 to $9,250, and, as a result, D's itemized deductions would have been reduced from $12,500 to $11,750, which is less than the standard deduction of $12,000 that D would have taken in 2018. The difference between D's claimed itemized deductions ($12,500) and the standard deduction D could have taken ($12,000) is $500. D received a tax benefit from $500 of the overpayment of state income tax in 2018. Thus, D is required to include $500 of D's state income tax refund in D's gross income in 2019.

4. A stockbroker could not assign income to his defunct corporation, says the Tax Court. Frey v. Commissioner, T.C. Memo. 2019-62 (6/3/19). The taxpayer, who began working as a stockbroker in 1962, was the chief operating officer of three firms, including Queen City Securities and Jettrade, Inc. During the years in question, 2012 and 2013, the taxpayer was the sole shareholder of Queen City Securities and served as president and chief executive officer of Jettrade, in which he held a majority equity interest. Following a series of financial crises, Queen City ceased to conduct business in 1990. The taxpayer claimed that Queen City had net operating losses or bad debt losses carried forward from years prior to 1991. During 2012 and 2013, the taxpayer received compensation from Jettrade of $214,150 and $205,300, respectively, and assigned all of the income to Queen City. He prepared his own federal income tax returns for 2012 and 2013 (in part because he had been

dissatisfied with and fired professionals with whom he had worked in the past), which included a Schedule C, Profit or Loss from Business, on which he reported that he worked as a stockbroker as a sole proprietor. On Schedule C, the taxpayer included as income the compensation he received from Jettrade and deducted equal amounts as "commissions and fees" for amounts he allegedly paid to Queen City with the intent to utilize Queen City's loss carryforwards to offset the income. The IRS disallowed the deductions on Schedule C for the amounts paid to Queen City and, as a result, made computational adjustments to increase the taxable portion of the Social Security benefits received by the taxpayer and his wife. The Tax Court (Judge Cohen) agreed with the IRS and held that the taxpayer could not assign his income to Queen City. According to the court, it is well established by cases such as *Lucas v. Earl*, 281 U.S. 111 (1930), that income is taxable to the person who earns it. The proper taxpayer is the person or entity that controls the earning of the income, not the person or entity that ultimately receives it. The court rejected the taxpayer's rather confused arguments to the contrary, concluded that he had presented no evidence that he had actually transferred funds to Queen City, and also concluded that his testimony at trial was implausible and unreliable and not entitled to any weight. The court upheld the IRS's imposition of accuracy-related penalties under § 6662(a), (b)(1) and (b)(2) for both substantial understatement of income tax and negligence. The IRS established that there was a substantial understatement of income because the understatement exceeded the greater of 10% of the tax required to be shown on the return or $5,000. The court also held that the evidence established that the taxpayer and his wife were negligent because "they did not consult competent professionals or otherwise attempt to determine their correct tax liabilities." They did not establish a reasonable cause defense.

5. Only a portion of more than $350,000 of canceled debt was excluded from an individual's gross income because only a small portion was qualified principal residence indebtedness and the individual was insolvent by approximately $43,000, says the Tax Court. Bui v. Commissioner, T.C. Memo. 2019-54 (5/21/19). Mary Bui ultimately acquired sole ownership of real property in San Jose, California, known as the Red River property, which she used as her principal residence until it was sold in a short sale on March 14, 2011. After the sale of the Red River property in 2011, the taxpayer moved into other real property she owned in San Jose, known as the Cedar Grove property, and made it her principal residence. Prior to the date she moved in, the Cedar Grove property had been a rental property. In 2007, the taxpayer obtained three home equity lines of credit from Wells Fargo, one of which was secured by the Red River property and two of which were secured by the Cedar Grove property. The taxpayer spent $10,000 in 2007 for custom drapes and $12,000 in 2008 for driveway repair and expansion work at the Red River property and testified to a number of other improvements to the property but provided no documentation of those other expenditures. She provided no evidence of improvements to the Cedar Grove property. In 2011, Wells Fargo canceled the three home equity lines of credit and issued Forms 1099-C reporting total canceled indebtedness of $355,488. On her federal income tax return for 2011, the taxpayer excluded all of the canceled debt from gross income as qualified principal residence indebtedness pursuant to § 108(a)(1)(E) (a provision that expired at the end of 2017). The IRS took the position that she had to include all of the canceled debt in her gross income.

Only $12,000 of the canceled debt was qualified principal residence indebtedness. The Tax Court (Judge Goeke) first concluded that, of the $355,488 of canceled debt, only $12,000 met the definition of "qualified principal residence indebtedness." That term is defined in § 108(h)(2), which provides that a taxpayer can treat up to $2 million as qualified principal residence indebtedness if the debt is "acquisition indebtedness (within the meaning of section 163(h)(3)(B) ... with respect to the principal residence of the taxpayer." The term "acquisition indebtedness," as defined in § 163(h)(3)(B), means indebtedness "incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer" that is "secured by such qualified residence." The Tax Court held that the two Wells Fargo lines of credit secured by the Cedar Grove property could not be qualified principal residence indebtedness because the taxpayer had not incurred the debt to acquire or improve that property. (Although not discussed by the court, another reason those lines of credit could not be qualified principal residence indebtedness was that, even if the taxpayer had used the loan proceeds to

make improvements to the Cedar Grove property prior to 2011, that property was not her principal residence at that time.) With respect to the Red River property, the court held that $10,000 the taxpayer had spent on custom drapes was not a "substantial improvement" to the property, but the $12,000 she had spent on driveway expansion and repair was a substantial improvement. The taxpayer had not substantiated any other improvements to the Red River property. The court also concluded that the taxpayer had used the line of credit loan proceeds to pay this $12,000 spent on driveway expansion and repair. Therefore, of the one Wells Fargo line of credit secured by the Red River property, only $12,000 was qualified principal residence indebtedness.

Of the $12,000 of qualified principal residence indebtedness, the taxpayer could exclude only $5,299 from her gross income. The Tax Court held that, of the $12,000 that was qualified principal residence indebtedness, the taxpayer could exclude from her gross income only $5,299 because of the limitation in § 108(h)(4). Section 108(h)(4) provides that, if only a portion of canceled debt is qualified principal residence indebtedness, then a taxpayer can exclude from gross income only "so much of the amount discharged as exceeds the amount of the loan (as determined immediately before such discharge) which is not qualified principal residence indebtedness." In this case, the total amount of the loan secured by the Red River property was $250,000, of which $243,299 was canceled. Of the total $250,000 loan amount, $238,000 ($250,000-$12,000) was not qualified principal residence indebtedness. Therefore, under § 108(h)(4), the limit on the amount the taxpayer could exclude from gross income was $5,299 ($243,299 canceled debt-$238,000). The effect of the § 108(h)(4) limitation is to treat the taxpayer as having paid a portion of the loan that was qualified principal residence indebtedness and to treat Wells Fargo as having canceled the portion of the loan that was not qualified principal residence indebtedness. Of the $250,000 loan amount, Wells Fargo canceled $243,299, which means that $6,701 of the loan was paid from the proceeds of the short sale of the Red River property. In effect, § 108(h)(4) treats this payment of $6,701 as having been made on the $12,000 portion of the loan that was qualified principal residence indebtedness, which leaves only $5,299 ($12,000-$6,701) of qualified principal residence indebtedness that was canceled.

The taxpayer was insolvent by $42,852 and therefore could exclude this amount of canceled debt from her gross income. Under § 108(a)(1)(B), a taxpayer can exclude canceled debt from gross income if the taxpayer is insolvent, and § 108(a)(3) limits the exclusion to the amount by which the taxpayer is insolvent. For this purpose, the term "insolvent" is defined in § 108(d)(3), which provides that a taxpayer is insolvent to the extent that, immediately before the cancellation of indebtedness, the taxpayer's liabilities exceed the fair market value of the taxpayer's assets. As part of their preparation for trial in the Tax Court, the taxpayer and the IRS had stipulated that the taxpayer was insolvent to the extent of $42,852. Accordingly, the Tax Court held that the taxpayer could exclude this amount of the canceled debt from gross income (in addition to the $5,299 she could exclude from gross income as a cancellation of qualified principal residence indebtedness).

6. Congress has extended through 2020 the exclusion for discharge of qualified principal residence indebtedness. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title I, § 101 of the 2020 Further Consolidated Appropriations Act, retroactively extended through December 31, 2020 the § 108(a)(1)(E) exclusion for up to $2 million ($1 million for married individuals filing separately) of income from the cancellation of qualified principal residence indebtedness. Thus, the exclusion applies for calendar years 2018, 2019, and 2020. Amendment of 2018 returns might be necessary.

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).

2. The Tax Court reiterates that it does not have equitable power to change the statutory treatment of excess advance premium tax credits as an increase in tax. Kerns v. Commissioner, T.C. Memo 2019-14 (3/4/19). The taxpayers, a married couple, purchased health insurance for 2014 through Covered California, a health insurance exchange created under the Affordable Care Act. Based on their projected household income, they qualified for an advance payment of the premium tax credit authorized by § 36B. During 2014, the exchange made total payments to the health insurance issuer of $8,402. Generally, under §36B(c)(1), the premium tax credit is available to taxpayers whose household income is at least 100 percent but not more than 400 percent of the federal poverty line. For this purpose, § 36B(d)(2)(A) provides that household income is the sum of the modified adjusted gross income (MAGI) of the taxpayer and all family members required to file a tax return who are taken into account in determining family size. MAGI is defined in relevant part by § 36B(d)(2)(B) as adjusted gross income (AGI) increased by certain items. The AGI and MAGI for 2014 of the taxpayers, who had no dependents, was $97,061. This amount exceeded 400 percent of the federal poverty line, and therefore the taxpayers were not eligible for the § 36B premium tax credit. Because they had received advance credit payments, they were required by § 36B(f)(1) to reconcile the amount of the advance payments with the premium tax credit calculated on their return. The taxpayers did not report their advance credit payments on their 2014 return. The IRS ultimately issued a notice of deficiency disallowing the entire credit. Because they did not qualify for any premium tax credit and had received $8,402 in advance credit payments, they owed the entire $8,402 as a tax liability. The taxpayers asserted various state law claims against the health insurance issuer (Blue Shield) and Covered California, including false advertising, unfair business practices, and breach of duty. They argued that this alleged malfeasance nullified any tax liability arising from the excess advance premium tax credit payments. The Tax Court (Judge Lauber) held that it had no ability grant relief to the taxpayers. The court relied on its prior decision in *McGuire v. Commissioner*, 149 T.C. 254 (8/28/17), for the proposition that the statutory mandate of § 36B(f)(2)(A), which provides that tax liability "shall be increased" by the amount of any excess advance premium tax credit payments, is not subject to equitable exceptions.

3. Although the Tax Court found it more likely than not that the taxpayer's compulsive gambling was a side effect of his physician-prescribed Pramipexole, his gambling losses were not casualty losses. Mancini v. Commissioner, T.C. Memo. 2019-16 (3/4/19). The taxpayer earned good money and was a successful real estate investor who gambled occasionally, but never more than $100 at a time. When he was diagnosed with Parkinson's disease, his neurologist prescribed Pramipexole (the generic name for Mirapex). Although his symptoms improved, the taxpayer started doing "odd things."

> He vacuumed a lot and became compulsive about his cleanliness. He spent a week researching and obsessing over which mattress to buy. He started falling asleep suddenly while driving. He had suicidal thoughts. And he started gambling--a lot.

Over the next two years the taxpayer depleted his bank accounts and all but $10,000 of his retirement savings. He also sold his real estate for less than fair market value and used the proceeds to pay gambling debts. On the taxpayer's 2008 and 2009 returns, for which he retained a return preparer, he reported gambling winnings and deducted gambling losses up to the amount of his gambling winnings. He prepared his 2010 return himself and deducted gambling losses up to the amount of his gambling winnings, and also deducted a $603,000 casualty loss for "Investment Portfolio and Home." He later amended his 2008 and 2009 returns to claim large casualty losses. The IRS issued a notice of deficiency for 2010. The Tax Court (Judge Holmes) first concluded, based on expert testimony, that it was more likely than not that the taxpayer's compulsive gambling was a side effect of the Pramipexole he was taking. Nevertheless, the court held, the taxpayer's gambling losses were not casualty losses for two reasons. First, the court reasoned, physical damage to property is a prerequisite of a casualty-loss deduction, and the taxpayer had not suffered physical damage to property. "Mancini's depleted bank

accounts, and the money he left on the table when he made bad real-estate deals, didn't suffer any physical damage. Second, the manner in which casualty losses are calculated demonstrates that the taxpayer had not suffered a casualty loss. The amount of a casualty loss is the amount by which the fair market value of the property before the casualty exceeds the fair market value of the property after the casualty, reduced by the amount of any insurance proceeds recovered. In this case, the court reasoned, the taxpayer's losses occurred over three years, which is not "sudden" as required for a casualty loss, and it would be difficult or impossible to apply a before-and-after test to determine the amount of his loss because his "losses were necessarily the result of dozens or hundreds of individual gambling sessions and probably thousands of separate wagers." The court also held that, even if the losses were casualty losses, the taxpayer had failed to substantiate them. Finally the court declined to impose accuracy-related penalties under by § 6662(a) because the IRS had not introduced any evidence that the penalties had been "personally approved (in writing) by the immediate supervisor of the individual making [the initial] determination" of the penalty as required by § 6751(b)(1).

4. In determining eligibility for the § 36B premium tax credit, a taxpayer's modified adjusted gross income includes lump-sum Social Security benefits attributable to a prior year, even if the taxpayer has made an election under § 86(e). Johnson v. Commissioner, 152 T.C. No. 6 (3/11/19). Section 86(e) permits a taxpayer who receives a lump-sum Social Security payment that is attributable to a prior year to limit the portion that is taxed by electing to include in gross income only the portion of the payment equal to the increase in gross income that would have occurred had the taxpayer taken the payment into account in the prior year to which the payment is attributable. For example, assume that (1) a taxpayer receives a $100 lump-sum Social Security payment this year that is attributable to last year, (2) $60 of the payment would be included in gross income this year, and (3) if the taxpayer had taken the payment into account last year, only $40 would have been included in gross income. The taxpayer in this example could elect under § 86(e) to include in gross income this year only $40 of the payment. The issue in this case is the effect of a § 86(e) election on the calculation of a taxpayer's modified adjusted gross income (MAGI) for purposes of determining eligibility for the premium tax credit authorized by § 36B for individuals who meet certain eligibility requirements and purchase health insurance coverage under a qualified health plan through an Affordable Insurance Exchange. Generally, under §36B(c)(1), the premium tax credit is available to taxpayers whose household income is at least 100 percent but not more than 400 percent of the federal poverty line. For this purpose, § 36B(d)(2)(A) provides that household income is the sum of the MAGI of the taxpayer and all family members required to file a tax return who are taken into account in determining family size. MAGI is defined in relevant part by § 36B(d)(2)(B) as adjusted gross income increased by certain items, including:

> an amount equal to the portion of the taxpayer's social security benefits (as defined in section 86(d)) which is not included in gross income under section 86 for the taxable year.

The taxpayer in this case received total Social Security benefits in 2014 of $26,180, of which $11,092 was attributable to a lump-sum payment relating to 2013. By making a § 86(e) election, the taxpayer limited the taxable portion of the total benefits received in 2014 to $6,687. The taxpayer argued that his MAGI for 2014 as defined in § 36B(d)(2)(B) should include none of the $11,092 of Social Security benefits attributable to 2013 or, at most, should include only the portion of his 2013 benefits included in his gross income for 2014. The taxpayer focused on the statutory phrase "under section 86 for the taxable year" in § 36B(d)(2)(B) and argued that the statute required inclusion in MAGI for 2014 only benefits attributable to *the taxable year* (2014) for which the determination was being made, and not those attributable to 2013. The Tax Court (Judge Gerber) held that the taxpayer's § 86(e) election had no effect on the determination of the taxpayer's MAGI for 2014. According to the court:

> We hold that the text of the statute is not ambiguous and that petitioner must include in his MAGI all of the Social Security benefits received in 2014, irrespective of the section 86(e) election. As a result, petitioner's adjusted gross income is increased by the amount of Social Security benefits not included in gross income and, as explained below, his MAGI exceeds the established threshold for PTC eligibility by a relatively small amount.

5. 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. No. 15 (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.

6. Standard deduction for 2020. Rev. Proc. 2019-44, 2019-47 I.R.B. 1093 (11/6/19). The standard deduction for 2019 will be $24,800 for joint returns and surviving spouses (increased from $24,400), $12,400 for unmarried individuals and married individuals filing separately (increased from $12,200), and $18,650 for heads of households (increased from $18,350). For individuals who can be clained as dependents, the standard deduction cannot exceed the greater of $1,100 or the sum of $350 and the individual's earned income. The additional standard deduction amount for those who are legally blind or who are age 65 or older is $1,650 for those with the filing

status of single or head of household (and who are not surviving spouses) and is $1,300 for married taxpayers ($2,600 on a joint return if both spouses are age 65 or older).

7. Extension of the 7.5 percent threshold for deduction of medical expenses through 2020. Prior to the 2017 Tax Cuts and Jobs Act, medical expenses generally were deductible only to the extent they exceeded 10 percent of a taxpayer's adjusted gross income. For taxable years beginning after 2012 and ending before 2017, this threshold was reduced to 7.5 percent if the taxpayer or the taxpayer's spouse had attained age 65 by the close of the year. The 2017 Tax Cuts and Jobs Act, § 11027, amended § 213(f) to provide that the 7.5 percent threshold applies to all taxpayers for taxable years beginning after 2016 and ending before 2019, i.e., to calendar years 2017 and 2018. Further, the legislation provided that this threshold applies for purposed of both the regular tax and the alternative minimum tax. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title I, § 103 of the 2020 Further Consolidated Appropriations Act, retroactively extended this reduced threshold to taxable years beginning before January 1, 2021, i.e., to calendar years 2019 and 2020.

8. Mortgage insurance premiums paid through 2020 remain deductible . A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title I, § 102 of the 2020 Further Consolidated Appropriations Act, retroactively extended through December 31, 2020, the § 163(h)(3)(E) deduction (subject to the pre-existing limitations) for mortgage insurance premiums paid or accrued in connection with acquisition indebtedness with respect to a qualified residence of the taxpayer. Thus, these premiums are deductible for calendar years 2018, 2019, and 2020. Amendment of 2018 returns might be necessary.

9. A retroactive deduction for paying your child's college tuition. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title II, § 104 of the 2020 Further Consolidated Appropriations Act, retroactively extended through December 31, 2020, the § 222 above-the-line deduction for individuals of a limited amount ($0, $2,000, or $4,000, depending on the taxpayer's adjusted gross income) of qualified tuition and related expenses for higher education of the taxpayer, the taxpayer's spouse, or dependents. Thus, this deduction is available for calendar years 2018, 2019, and 2020. Amendment of 2018 returns might be necessary.

10. Deducting casualty losses in areas arising in qualified disaster areas just got easier. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title II, § 204(b) of the 2020 Further Consolidated Appropriations Act provides special rules for disaster losses in qualified disaster areas. Normally, a personal casualty loss is deductible only to the extent that it exceeds $100 and only to the extent the sum of all personal casualty losses exceeds 10 percent of adjusted gross income. The legislation provides that a "net disaster loss" is deductible only to the extent it exceeds $500 (rather than $100) and is deductible without regard to the normal 10-percent-of-AGI threshold. An individual with a net disaster loss can deduct the sum of any non-disaster personal casualty losses, which remain subject to the $100 and 10 percent thresholds, and the net disaster loss. For example, if an individual has AGI of $90,000, a non-disaster-related casualty loss of $10,000 from the theft of a personal car, and a net disaster loss of $50,000, then the individual can deduct $900 of the theft loss ($10,000 reduced by $100 reduced by 10 percent of AGI) and can deduct $49,500 of the net disaster loss ($10,000 reduced by $500). The deduction for the net disaster loss is available both to those who itemize their deductions and those who do not. For those who do not itemize, the standard deduction is increased by the amount of the net disaster loss. The disallowance of the standard deduction for purposes of determining alternative minimum taxable income does not apply to this increased portion of the standard deduction.

A net disaster loss is defined as the amount by which "qualified disaster-related personal casualty losses" exceed personal casualty gains. A qualified disaster-related personal casualty loss is a loss described in § 165(c)(3) (which generally defines casualty losses) that arises in a qualified disaster area on or after the first day of the incident period of the relevant qualified disaster and that is attributable to the qualified disaster.

- Rev. Proc. 2018-8, 2018-2 I.R.B. 286 (12/13/17), provides safe harbor methods that individual taxpayers can use in determining the amount of their casualty and theft losses for their personal-use residential real property and personal belongings. Additional safe harbor methods are available in the case of casualty and theft losses occurring as a result of any federally declared disaster. The IRS will not challenge an individual's determination of the decrease in fair market value of personal-use residential real property or personal belongings if the individual qualifies for and uses one of the safe harbor methods described in the revenue procedure. The revenue procedure is effective December 13, 2017.

Several key terms are defined in Division Q, Title II, § 201 of the 2020 Further Consolidated Appropriations Act. These are as follows:

1. The term "*incident period*" with respect to any qualified disaster is the period specified by FEMA as the period during which the disaster occurred, except that the period cannot be treated as beginning before January 1, 2018, or ending after January 19, 2020 (the date that is 30 days after the date of enactment of the legislation).
2. The term "*qualified disaster zone*" is the portion of the qualified disaster area determined by the President to warrant individual or individual and public assistance from the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of the qualified disaster with respect to the qualified disaster area.
3. The term "*qualified disaster area*" is an area with respect to which the President declared a major disaster from January 1, 2018, through February 18, 2020 (the date that is 60 days the date of enactment of the legislation), under section 401 of the Stafford Act if the incident period of the disaster began on or before December 20, 2019 (the date of enactment). To avoid providing double benefits, the legislation excludes the California wildfire disaster area, for which similar relief was provided by the Bipartisan Budget Act of 2018.
4. "The term '*qualified disaster*' means, with respect to any qualified disaster area, the disaster by reason of which a major disaster was declared with respect to such area."

11. Those affected by qualfied disasters can use prior-year earned income to determine their earned income tax credit and child tax credit. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title II, § 204(c) of the 2020 Further Consolidated Appropriations Act provides that a "qualified individual" can elect to use prior-year earned income for purposes of determining the individual's earned income tax credit under § 32 and child tax credit under § 24. The election is available for qualified individuals whose earned income for the "applicable tax year" is lower than their earned income for the preceding tax year. A *qualified individual* is defined as an individual whose principal place of abode at any time during the incident period of any qualified disasterwas located (1) in the qualified disaster zone with respect to the qualified disaster, or (2) outside the qualified disaster zone, but within the qualified disaster area with rspect to the disaster, if the individual was displaced from his or her principal place of abode by reason of the qualified disaster. The term *applicable tax year* is defined differently for qualified individals in these two categories. For those in the second category (those outside a qualified disaster zone who are displaced), the applicable tax year is any taxable year that includes any portion of the period during which they were displaced. For those in the first category (those within a qualified disaster zone), the applicable tax year is any taxable year date that includes any portion of the incident period of the qualified disaster. If a qualified individual makes this election, it applies for purpose of both the earned income tax credit and the child tax credit. For married couples filing a joint return, the election is available if either spouse is a qualified individual, and the earned income for the preceding year is the sum of the earned income in the preceding year of both spouses.

E. Divorce Tax Issues

F. Education

1. Amounts can be withdrawn tax-free from § 529 accounts to pay expenses of apprenticeship programs and an aggregate amount of $10,000 can be withdrawn tax-free from § 529 accounts to repay qualified education loans of the beneficiary or a sibling. A provision of the SECURE Act, Division O, Title 3, § 302 of the 2020 Further Consolidated Appropriations Act, amended Code § 529 to add § 529(c)(8), which permits tax-free distributions from § 529 accounts to pay "expenses for fees, books, supplies, and equipment required for the participation of a designated beneficiary in an apprenticeship program" registered under the National Apprenticeship Act. The legislation also added § 529(c)(9), which permits tax-free distributions from § 529 accounts to pay "principal or interest on any qualified education loan (as defined in section 221(d)) of the designated beneficiary or a sibling of the designated beneficiary." The limit on distributions for repayment of educational loans is *an aggregate* of $10,000. Amounts withdrawn to pay a sibling's educational loans count against the sibling's aggregate $10,000 limit, not the limit of the designated beneficiary. To the extent that amounts withdrawn tax-free from a § 529 account are used to pay interest on an educational loan, the taxpayer's deduction for student loan interest under § 221 is reduced. These changes apply to distributions made after December 31, 2018.

G. Alternative Minimum Tax

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

1. Now, this is "fake news" if we've ever heard it: The IRS has ruled that a redemption which does not qualify under § 302 is a distribution under § 301. Duh! Rev. Rul. 2019-13, 2019-20 I.R.B. 1179 (5/9/19). For reasons we're apparently too dense to understand, the IRS has found it necessary to rule that a redemption by a C corporation which does not qualify under § 302 is treated as a distribution under § 301. *Shocking!* Okay, to be fair, the ruling also holds (not surprisingly) that if the C corporation's nonqualifying redemption takes place during the corporation's "post-termination transition period" (as defined in § 1377(b)) after converting from subchapter S status, the distribution reduces the former S corporation's accumulated adjustment account ("AAA") before reducing earnings and profits ("E&P") accumulated from prior C corporation years.

Facts. The facts set forth in Rev. Rul. 2019-13 are as follows: X once was a C corporation and later elected S status under § 1362(a). Then, X's S election terminated under § 1362(d), such that it is now a C corporation. A, an individual, owns all 100 shares of the outstanding stock of X. At the time of its conversion to an S corporation, X had accumulated E&P of $600x and no current E&P. At the time of the termination of its S election, X's AAA was $800x and its accumulated E&P was still $600x. During X's post-termination transition period, X redeems 50 of A's 100 shares of X stock for $1,000x. X makes no other distributions during the post-termination transition period. For the taxable period that includes the redemption, X has current E&P of $400x.

Law and Analysis: Recall that because A still owns 100 percent of the stock of X after the redemption, the transaction does not qualify for sale or exchange treatment under § 302 and therefore is treated as distribution under § 301. Further recall that the "post-termination transition period" under § 1377(b) generally is the one-year period following the termination of a corporation's subchapter S status. Under § 1371(e), any distribution of cash by a former S corporation with respect to its stock during the post-termination transition period ordinarily is applied against and reduces the adjusted basis of the recipient's stock to the extent the distribution does not exceed the corporation's AAA (within the meaning of § 1368(e)).

Held, the redemption of 50 of A's 100 shares of X stock for $1,000x is characterized as a reduction of X's $800x of AAA with the remaining $200x characterized as a dividend under § 301(c)(1).

2. Thirty years after the Technical and Miscellaneous Revenue Act of 1988, the regulations under § 301 are proposed to be updated to make conforming changes. REG-21694-16, Updating Section 301 Regulations to Reflect Statutory Changes, 84 F.R. 11263 (3/26/19). The Technical and Miscellaneous Revenue Act of 1988 amended § 301(b)(1) and § 301(d), effective as if the amendments had been included in the Tax Reform Act of 1986, to eliminate certain distinctions that previously existed between corporate and non-corporate distributees and certain special rules for distributions to or from foreign corporations. As amended, these statutory provisions state that the amount of a corporate distribution is the amount of money received plus the fair market value of property received (§ 301(b)(1)), and that the basis of property received from a corporation is the fair market value of that property (§ 301(d)). These proposed amendments update Reg. § 1.301-1 to reflect these changes and make certain non-substantive changes including modifying cross-references and reorganizing some provisions. Although the proposed regulations would be effective when published as final regulations, the statutory changes that they reflect are already effective.

3. Treasury and the IRS have withdrawn the 2009 proposed regulations on allocation of consideration and allocation and recovery of basis in transactions involving corporate stock. REG-143686-07, The Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities; Withdrawal, 84 F.R. 11686 (3/28/19). In 2009, Treasury and the IRS published proposed regulations under §§ 301, 302, 304, 351, 354, 356, 358, 368, 861, 1001, and 1016 regarding the recovery of stock basis in (1) § 301 distributions and transactions that are treated as § 301 distributions, and (2) sale and exchange transactions to which § 302(a) applies (including certain aspects of reorganization exchanges). The proposed regulations also provided the method for determining gain realized under § 356 and made a number of clarifying, but nonsubstantive, modifications to the rules for determining stock basis under § 358 resulting from a reorganization. The core principle underlying the rules was that each share of stock is a separate unit of property that can be sold or exchanged and the results of a transaction should be determined with respect to the consideration received in regard to each share. After considering comments submitted on the proposed regulations, Treasury and the IRS "determined that it is unlikely that approach of the 2009 Proposed Regulations can be implemented in comprehensive final regulations without significant modifications." Accordingly, Treasury and the IRS have withdrawn the 2009 proposed regulations and will continue to study the issues addressed in them "with a particular focus on issues surrounding sections 301(c)(2) and 304, and [Reg.] § 1.302-2(c)." The notice of withdrawal published in the Federal Register reiterates the belief of Treasury and the IRS in the core principle underlying the 2009 proposed regulations:

> The Treasury Department and the IRS continue to believe that under current law, the results of a section 301 distribution should derive from the consideration received by a shareholder in respect of each share of stock, notwithstanding designations otherwise. See *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971). The Treasury Department and the IRS also continue to believe that, under current law, with respect to redemptions governed by section 302(d), any unrecovered basis in the redeemed stock of a shareholder may be shifted to other stock only if such an adjustment is a proper adjustment within the meaning of [Reg.] § 1.302-2(c). Not all shifts of a redeemed shareholder's unrecovered basis result in proper adjustments, and certain basis adjustments can lead to inappropriate results. See, e.g., Notice 2001-45, 2001-33 I.R.B. 129.

C. Liquidations

D. S Corporations

1. A § 267 "looptrap" snares an accrual-method subchapter S corporation with an ESOP shareholder. Petersen v. Commissioner, 148 T.C. 463 (6/13/17). The taxpayers, a married couple, owned stock in an accrual-method S corporation with many employees. As permitted by § 1361(c)(7), an ESOP benefitting the employees also owned stock in the S corporation. The S corporation had accrued and deducted the following amounts with respect to its ESOP participants as

of the end of its 2009 and 2010 tax years: for 2009, unpaid wages of $1,059,767 (paid by January 31, 2010) and vacation pay of $473,744 (paid by December 31, 2010); for 2010, unpaid wages of $825,185 (paid by January 31, 2011) and vacation pay of $503,896 (paid by December 31, 2011). Notwithstanding the fact that the S corporation was an accrual-method taxpayer, the IRS asserted under § 267(a)(2) (forced-matching) that the corporation was not entitled to deduct the foregoing accrued amounts until the year of actual payment and inclusion in gross income by the ESOP's cash-method, employee-participants. In a case of first impression, the Tax Court (Judge Lauber) agreed with the IRS based upon a plain reading of §§ 67(a)(2), (b), and (e), as well as a determination that the S corporation's ESOP is a "trust" within the meaning of § 267(c). Specifically, § 267(a)(2) generally requires so-called "forced matching" of an accrual-method taxpayer's deductions with the gross income of a cash-method taxpayer to whom a payment is to be made if the taxpayer and the person to whom the payment is to be made are related persons as defined by § 267(b). For an S corporation, pursuant to § 267(e), all shareholders are considered related persons under § 267(b) regardless of how much or how little stock such shareholders actually *or constructively* own. Furthermore, under § 267(c) beneficiaries of a trust are deemed to own any stock held by the trust. Because the assets held by an ESOP are owned by a trust (as required by ERISA, *see* 29 U.S.C. § 1103(a)), the participating employees of the ESOP are treated as shareholders of the S corporation. Hence, the forced-matching rule of § 267(a)(2) applies to accrued but unpaid wages and vacation pay owed to the S corporation's ESOP participants at the end of the year. Judge Lauber noted that this odd situation probably was a "drafting oversight"—in our words, a *looptrap*—because § 318, which defines related parties for certain purposes under subchapter C, excepts tax-exempt employee trusts from its constructive ownership rules. Nevertheless, Judge Lauber wrote, the Tax Court is "not at liberty to revise section 267(c) to craft an exemption that Congress did not see fit to create." Mercifully, however, the Tax Court declined to impose § 6662 negligence or substantial understatement penalties on the taxpayers because the case was one where "the issue was one not previously considered by the Court and the statutory language was not clear" (even though the court obviously relied upon the plain language of § 267 to reach its decision).

a. This accrual-method S corporation was properly snared, says the Tenth Circuit. Petersen v. Commissioner, 924 F.3d 1111 (10th Cir. 5/15/19), *aff'g* 148 T.C. 463 (6/13/17). In an opinion by Judge Hartz, the U.S. Court of Appeals for the Tenth Circuit has affirmed the Tax Court's decision that an accrual-method S corporation's deductions for amounts payable to cash-method participants in an ESOP that held shares of the S corporation were deferred by the forced matching rule of § 267(a)(2). Section 267(a)(2) provides that the deductions of an accrual-method taxpayer for amounts payable to a related cash-method taxpayer must be deferred until the year in which the amounts are included in the related taxpayer's gross income. Under § 267(c), beneficiaries of a trust are treated as constructively owning any stock held by the trust. Further, under § 267(e), all shareholders of an S corporation are treated as "related persons" within the meaning of § 267(b) regardless of how much or how little stock such shareholders actually *or constructively* own. The Tenth Circuit agreed with the Tax Court that the effect of these provisions is that employees of an S corporation who participate in an ESOP that holds shares of the S corporation are "related persons" with respect to the S corporation within the meaning of § 267(b), and therefore an accrual-method S corporation's deductions for amounts payable to such employees are subject to deferral under the forced-matching rule of § 267(a)(2). In reaching this conclusion, the court rejected several arguments made by the taxpayers and held that an ESOP is a "trust" within the meaning of § 267(c), and therefore the ESOP's participants are treated as constructively holding proportionately the stock held by the ESOP.

2. In line with the continuing expansion of eligible shareholders of subchapter S corporations, ESBTs now may have non-U.S. individuals as current beneficiaries. The 2017 Tax Cuts and Jobs Act, § 13541, makes a technical change to § 1361(c)(2)(B)(v) such that for 2018 and future years an "electing small business trust" (an "ESBT," as particularly defined in § 1361(e)) may have as a current beneficiary of the ESBT a "nonresident alien" individual. Under § 7701(b)(1)(B), a

nonresident alien individual is a person who is neither a citizen nor a resident of the U.S. This change to § 1361 is permanent.

a. Final regulations address the treatment of ESBTs that are S corporation shareholders and have nonresident aliens as beneficiaries. T.D. 9868, Electing Small Business Trusts With Nonresident Aliens as Potential Current Beneficiaries, 84 F.R. 28214 (6/18/19). The Treasury Department and the IRS have finalized without change proposed regulations (REG-117062-18, Electing Small Business Trusts With Nonresident Aliens as Potential Current Beneficiaries, 84 F.R. 16415 (4/19/19)) addressing the treatment of electing small business trusts that are S corporation shareholders and have nonresident aliens as beneficiaries. The preamble to the proposed regulations noted the apparent assumption in the legislative history of the 2017 Tax Cuts and Jobs Act that an ESBT is subject to tax and therefore would be subject to tax on the ESBT's share of the S corporation's income. That preamble notes, however, that ESBTs can be grantor trusts for federal tax purposes with the result that the beneficiaries of the ESBT, not the ESBT itself, are subject to tax on the S corporation's income. If a nonresident alien is a beneficiary of an ESBT, this could lead to the S corporation's income not being subject to U.S. taxation (e.g., if the income is foreign-source). Therefore, according to the preamble to the proposed regulations, the regulations generally

> would modify the allocation rules under § 1.641(c)-1 to require that the S corporation income of the ESBT be included in the S portion of the ESBT if that income otherwise would have been allocated to an NRA deemed owner under the grantor trust rules. Accordingly, such income would be taxed to the domestic ESBT by providing that, if the deemed owner is an NRA, the grantor portion of net income must be reallocated from the grantor portion of the ESBT to the ESBT's S portion.

The final regulations apply to all ESBTs after December 31, 2017.

3. We humbly ask, "Does it ever make sense to hold real estate in an S corporation?" And, "Will taxpayers ever learn that a series of 'due tos' and 'due froms' with related entities doesn't amount to shareholder debt for purposes of subchapter S?" Meruelo v. Commissioner, 923 F.3d 938 (11th Cir. 5/6/19). The taxpayer was a shareholder of an S corporation that suffered nearly a $27 million loss after banks foreclosed on its condominium complex. The taxpayer contended that he had sufficient basis in the S corporation's indebtedness to him to absorb his $13 million share of the S corporation's loss. According to the taxpayer, his basis stemmed from his $5 million capital contribution to the S corporation plus more than $9 million of net indebtedness owed to various other business entities in which the taxpayer owned an interest. Essentially, the $9 million of indebtedness for which the taxpayer claimed basis was derived from netting the S corporation's accounts payable and accounts receivable with respect to other entities controlled by the taxpayer. The IRS contended, however, that the taxpayer could claim only $5 million in losses because the net indebtedness owed by the S corporation to the taxpayer's other business entities was not "bona fide indebtedness" that "runs directly" to the taxpayer. *See* § 1366; Reg. § 1.1366-2(a)(2)(i). The Tax Court had held in favor of the IRS, upholding the IRS's asserted deficiency of approximately $2.6 million, and the Eleventh Circuit, in an opinion by Judge Pryor, affirmed the Tax Court's decision. Judge Pryor acknowledged, as did the Tax Court, that under the right circumstances either the "back-to-back" loan theory (*see* Reg. § 1.1366-2(a)(2)(iii) Ex. 2) or the "incorporated pocketbook" theory (*see Yates v. Comm'r*, 82 T.C.M. (CCH) 805 (2001); *Culnen v. Comm'r*, 79 T.C.M. (CCH) 1933 (2000), *rev'd on other grounds*, 28 F. App'x 116 (3d Cir. 2002)) argued by the taxpayer can support a taxpayer-shareholder's claim of basis for S corporation debt owed to another party; however, the facts of the taxpayer's case were nothing like the facts in cases premised upon the "back-to-back" loan theory or the "incorporated pocketbook" theory. There was no mention in Judge Pryor's opinion of the IRS's assertion of accuracy-related penalties against the taxpayer. *Perhaps the IRS has a heart after all . . . .*

E. Mergers, Acquisitions and Reorganizations

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

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

a.Taxpayers have sufficient guidance on continuity of interest and the proposed regulations issued in 2011 are withdrawn. REG-124627-11, Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest, 84 F.R. 12169 (4/1/19). As indicated earlier, since 2011, final regulations under § 368 generally have permitted the determination of whether the continuity of interest (COI) requirement is satisfied to be based on the actual trading value of a publicly-traded acquiring corporation's stock on either the closing date (as defined) or the signing date (as defined). See Reg. § 1.368-(e)(2). Proposed regulations promulgated in 2011 under § 368 provide in part that, under specified circumstances, certain average trading price determinations of

value (rather than actual trading value on a specific date) are allowed for determining whether the COI requirement is satisfied. See Prop. Reg. § 1.368-1(e)(2)(vi)(A). Treasury and the IRS have concluded that current law generally provides sufficient guidance to taxpayers with respect to the COI requirement. Accordingly, the proposed regulations issued in 2011 have been withdrawn. However, because the IRS also has concluded that taxpayers in certain circumstances should be able to rely on average stock valuation methods for purposes of measuring COI, the IRS issued Rev. Proc. 2018-12, discussed above, which specifies the circumstances in which the IRS will not challenge the use of certain average stock valuation methods in determining whether the COI requirement is satisfied.

2. 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.

F. Corporate Divisions

1. The IRS has suspended two old revenue rulings on the active trade or business requirement of §§ 355(a)(1)(C) and (b). Rev. Rul. 2019-9, 2019-14 I.R.B. 925 (3/21/19). If certain requirements are met, § 355(a)(1) permits a corporation to distribute stock and securities of a controlled corporation to its shareholders and security holders without recognizing gain or loss and without income to the recipients. One of those requirements is that the distributing corporation and the controlled corporation must be engaged in an active trade or business immediately after the distribution. I.R.C. §§ 355(a)(1)(C), 355(b); Reg. § 1.355-3(a)(1)(i). To qualify, each trade or business must have been actively conducted throughout the five-year period ending on the date of the distribution. I.R.C. § 355(b)(2)(B); Reg. § 1.355-3(b)(3). Under Reg. § 1.355-3(b)(2)(ii), a "trade or business" is "a specific group of activities … being carried on by the corporation for the purpose of

earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit." The same regulation further provides that "[s]uch group of activities ordinarily must include the collection of income and the payment of expenses." In Rev. Rul. 57-464, 1957-2 C.B. 244, and Rev. Rul. 57-492, 1957-2 C.B. 247, the IRS concluded that certain activities conducted by a corporation did not meet the active trade or business requirement largely because the activities had failed to generate income. The IRS has suspended these rulings pending the completion of a study by the Treasury Department and the IRS. The study, which was previously announced in a statement on the IRS website dated September 25, 2018, concerns

> [possible] guidance to address whether a business can qualify as an [active trade or business] if entrepreneurial activities, as opposed to investment or other non-business activities, take place with the purpose of earning income in the future, but no income has yet been collected.

Pending completion of this study, the IRS will entertain requests for private letter rulings regarding the qualification as an active trade or business of corporations that have not collected income.

A subsequent statement on the IRS website dated May 6, 2019, requests information in a number of categories to assist the IRS in identifying entrepreneurial activities that do not generate income but nevertheless should qualify as an active trade or business and explains the rationale for the study as follows:

> In recent years, the IRS has observed a significant increase in entrepreneurial ventures that collect little or no income during lengthy and expensive R&D phases, particularly pharmaceutical and technology ventures. However, these types of ventures often use the R&D phase to develop new products that will generate income in the future but do not collect income during that phase. If a corporation wishes to achieve a corporate-level business purpose by separating one R&D segment from an established business or from another R&D segment, the IRS's historical application of the income collection requirement likely would present a challenge for section 355 qualification.

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

1. Cash grants from the State of New Jersey were nontaxable contributions to capital, says the Tax Court. Brokertec Holdings, Inc. v. Commissioner, T.C. Memo. 2019-32 (4/9/19). The taxpayer in this case was the common parent of a consolidated corporate group. Two members of the group were inter-dealer brokers with offices in or near the World Trade Center in New York City on September 11, 2001. Following the destruction of the World Trade Center in the September 11 terrorist attack, these members searched for new office space. They both applied for and received cash grants from the State of New Jersey's Economic Development Plan. Both members relocated to areas of New Jersey adjacent to New York City. On the consolidated group's returns for 2010 through 2013, a total of approximately $55.7 million of the cash grants were treated as nontaxable, nonshareholder contributions to capital under § 118. The IRS asserted that the group was required to include the grants in gross income. The Tax Court (Judge Jacobs) held that the grants were nontaxable contributions to capital. The court engaged in a lengthy review of prior cases that had addressed the issue of what constitutes a contribution to capital, including the U.S. Supreme Court's decision in *Brown Shoe Co. v. Commissioner*, 339 U.S. 583 (1950), and the Third Circuit's decision in *Commissioner v. McKay Prods. Corp.*, 178 F.2d 639 (3d Cir. 1949). Based on this review, the court concluded that "the key to determining whether payments from a nonshareholder (here the State of New Jersey) are taxable to the recipient (here petitioner's affiliates) or nontaxable as a contribution to capital is the intent or motive of the nonshareholder donor." In this case, the court concluded, the intent of the State of New Jersey in making the grants was not to pay for services, but rather to induce the consolidated group members to establish their offices in a targeted area (known as an urban-aid municipality) both to bring in new jobs and to revitalize the area. "The facts in this case fall squarely within the four corners of section 1.118-1, Income Tax Regs., and are strikingly similar to those of

Brown Shoe Co. and McKay Prods. Corp. …" Accordingly, the court held, the grants were nontaxable, nonshareholder contributions to capital.

- The 2017 Tax Cuts and Jobs Act, § 13312, amended Code § 118 effective after December 22, 2017, such that nonshareholder contributions to the capital of corporations made by governmental entities or civic groups no longer are excludable from the recipient corporation's gross income. Accordingly, the result in this case would have been different if the years involved were subject to amended § 118.

- Any appeal of the Tax Court's decision by the government will be heard by the U.S. Court of Appeals for the Third Circuit, the same court that issued the opinion in *McKay Prods. Corp.*

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

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

Deemed Redemption Rule. Under the deemed redemption rule, a corporate partner in a partnership that engages in a Section 337(d) Transaction must recognize gain at the time, and to the extent, that the corporate partner's interest in appreciated property (other than stock of the corporate partner) is reduced in exchange for an increased interest in stock of the corporate partner. The complicated deemed redemption rule is triggered by the partnership's purchase of stock of a corporate partner (or stock or other equity interests of any corporation that controls the corporate partner within the meaning of § 304(c), except that § 318(a)(1) and (3) do not apply for that purpose); gain recognition can be triggered without a subsequent distribution. The regulations provide general principles that apply in determining the amount of appreciated property effectively exchanged for stock of the corporate partner. The corporate partner's economic interest with respect to both the stock of the corporate partner and all other appreciated property of the partnership must be determined based on all facts and circumstances, including the allocation and distribution rights set forth in the partnership agreement. The gain from the hypothetical sale used to compute gain under the deemed redemption rule is determined by applying the principles of § 704(c). The corporate partner's recognition of gain from a Section 337(d) Transaction triggers two basis adjustments. First, the partnership increases its adjusted basis in the appreciated property that is treated as the subject of a Section 337(d) Transaction by the amount of gain that the corporate partner recognizes with respect to that property as a result of the Section 337(d) Transaction regardless of whether the partnership has a § 754 election in effect.

Second, the basis of the corporate partner's interest in the partnership is increased by the amount of gain the corporate partner recognizes. In limited circumstances, a partnership's acquisition of stock of the corporate partner does not have the effect of an exchange of appreciated property for that stock. For example, if a partnership with an operating business uses the cash generated in that business to purchase stock of the corporate partner, the deemed redemption rule does not apply because the corporate partner's share in appreciated property has not been reduced, and thus no exchange has occurred. The rules also do not apply if all interests in the partnership's capital and profits are held by members of an affiliated group (defined in § 1504(a)) that includes the corporate partner.

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

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

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

a. We thought the final regulations on partnership transactions involving equity interests of partners were already sufficiently complex. Proposed regulations modify certain key definitions. REG-135671-17, Partnership Transactions Involving Equity Interests of a Partner, 84 F.R. 11005 (3/25/19). These proposed regulations modify certain definitions in the final regulations that were issued in June 2018 to address so-called "May Company" transactions. See T.D. 9833, Partnership Transactions Involving Equity Interests of a Partner, 83 F.R. 26580 (6/8/18). The deemed redemption rule in the final regulations is triggered when a corporate partner exchanges an interest in appreciated property for an interest in "Stock of the Corporate Partner" owned, acquired, or distributed by the partnership. The final regulations generally define Stock of a Corporate Partner as stock, or other equity interests, including options, warrants, and similar interests, in the Corporate Partner or a corporation that controls the Corporate Partner within the meaning of § 304(c) (except that § 318(a)(1) and (3) do not apply). The proposed regulations would make four amendments to the final regulations.

First, the final regulations excluded the attribution rules of § 318(a)(1) and (3) to limit for this purpose the meaning of control as defined in § 304(c) (generally stock possessing 50 percent or more of total combined voting power or value) to entities that own a direct or indirect interest in the corporate partner. Out of concern that excluding the attribution rules of § 318(a)(1) and (3) in determining control would allow taxpayers to structure transactions to eliminate gain on appreciated assets the proposed regulations eliminate the exclusion of the attribution rules of § 318(a)(1) and (3) in determining control. Instead, according to the preamble, the proposed regulations implement the rationale for the prior exclusion of the attribution rules more directly:

> For the purpose of testing direct or indirect ownership of an interest in the Corporate Partner, ownership of Stock of the Corporate Partner would be attributed to an entity under section 318(a)(2) (except that the 50-percent ownership limitation in section 318(a)(2)(C) would not apply) and under Section 318(a)(4), but otherwise without regard to section 318. Thus, sections 318(a)(1), 318(a)(3), and 318(a)(5) would not apply for determining whether an entity directly or indirectly owns an interest in Stock of the Corporate Partner, but once an entity is found to directly or indirectly own an

interest in such stock, then the section 304(c) control definition would apply in its entirety to determine whether the tested entity is a Controlling Corporation.

Second, the proposed regulations would modify the rule in the 2018 final regulations that Stock of a Corporate Partner does not include any stock or equity interest held or acquired by a partnership if all interests in the partnership's capital and profits are held by members of an affiliated group within the meaning of § 1504(a) (the "Affiliated Group Exception")." Out of concern that the Affiliated Group Exception may result in abuse, Treasury and the IRS propose to remove the Affiliated Group Exception from the regulations and have requested comments describing situations in which a more tailored version of it might be appropriate.

Third, the proposed regulations would make certain modifications to the rule in the 2018 final regulations that Stock of the Corporate Partner includes interests in any entity to the extent that the value of the interest is attributable to Stock of the Corporate Partner (the so-called value rule).

Finally, the proposed regulations would make certain conforming changes to the exception for certain dispositions of stock in Reg. § 1.337(d)–3(f)(2). The proposed regulations would be effective on the date they are published as final regulations in the Federal Register, but taxpayers may rely on them for transactions occurring on or after June 12, 2015, provided that the taxpayer consistently applies the proposed regulations to such transactions.

D. Sales of Partnership Interests, Liquidations and Mergers

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

The court first analyzed the nature of the gain realized by the taxpayer. Under § 736(b)(1), payments made in liquidation of the interest of a retiring partner that are made in exchange for the partner's interest in partnership property are treated as a distribution to the partner. Treatment as a distribution triggers § 731(a)(1), which provides that a partner recognizes gain from a distribution to the extent the amount of money received exceeds the partner's basis in the partnership interest and directs that the gain recognized "shall be considered as gain or loss from the sale or exchange of the

partnership interest of the distributee partner." Pursuant to § 741, gain recognized from the sale or exchange of a partnership interest is "considered as gain or loss from the sale or exchange of a capital asset" except to the extent provided by § 751. (The IRS did not contend that § 751 applied.) The taxpayer asserted that these provisions lead to the conclusion that the taxpayer's gain must be treated as arising from the sale of a single asset, its partnership interest, which is a capital asset. The government argued that the taxpayer's gain must be treated as arising from the sale of separate interests in each asset owned by the partnership. Otherwise, the government argued, the rule in § 897(g), which imposes U.S. tax to the extent amounts received from the sale of a partnership interest are attributable to U.S. real property interests, would be rendered inoperable. The court agreed with the taxpayer. Section 897(g), the court explained,

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

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

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

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

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

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

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

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

b. Temporary guidance on new withholding rules with respect to dispositions of partnership interests by non-U.S. partners, but publicly-traded partnerships get a "temporary" pass. Notice 2018-8, 2018-7 I.R.B. 352 (1/2/18) and Notice 2018–29, 2018-16 I.R.B. 495 (4/2/18). As mentioned above, TCJA § 13501 added new § 1446(f) to require that where § 864(c)(8) applies the transferee of a non-U.S. partner's partnership interest must withhold, report, and pay over a tax equal to 10 percent of the amount realized upon the disposition (unless specified exceptions apply) effective for transfers after December 31, 2017. Practitioners objected to immediate implementation of the new withholding rules, pointing out that without forms, instructions or other guidance, it was unclear when or how to deposit the withheld amounts. To address these concerns, Notice 2018-29 provides interim guidance on reporting and paying over the amount required to be withheld under section 1446(f)(1). For details, Notice 2018-29 should be consulted by taxpayers affected by new § 864(c)(8), but generally speaking, the temporary guidance adopts the forms and procedures relating to withholding on dispositions of U.S. real property interests under section 1445 and the regulations thereunder. With respect to publicly-traded partnerships, however, Notice 2018-8 announces that Treasury and the IRS have determined that withholding under new section 1446(f) is not required with respect to any disposition of an interest in a publicly-traded partnership (within the meaning of section 7704(b)) until regulations or other guidance have been issued. Notice 2018-8 emphasizes that this temporary suspension is limited to dispositions of interests that are publicly traded and does not extend to non-publicly traded interests.

c. Proposed regulations implementing new § 864(c)(8) issued. REG-113604-18, Gain or Loss of Foreign Persons From Sale or Exchange of Certain Partnership Interests, 83 F.R. 66647 (12/27/18). Treasury and the IRS have issued proposed regulations that implement new § 864(c)(8). As required by § 864(c)(8), the proposed regulations adopt a two-part analysis for determining effectively connected income or loss upon a foreign partner's sale or exchange of its partnership interest. First, § 864(c)(8)(A) requires a foreign partner to apply the normal rules of subchapter K to determine its overall gain or loss (including ordinary income or loss from "hot assets" under § 751) on the transfer of a partnership interest (''outside gain'' and ''outside loss''). Second, the outside gain or outside loss is compared to amounts determined under § 864(c)(8)(B), which can limit otherwise reportable effectively connected income or loss of the foreign partner. Consistent with the

IRS's position in *Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner*, 149 T.C. No. 3 (7/13/17), and Rev. Rul. 91-32, 1991-1 C.B. 107, § 864(c)(8)(B) uses a hypothetical partnership level sale or exchange analysis to derive inside ''aggregate deemed sale EC capital gain,'' ''aggregate deemed sale EC capital loss,'' ''aggregate deemed sale EC ordinary gain,'' and ''aggregate deemed sale EC ordinary loss.'' Outside gain or loss determined under § 864(c)(8)(A) then is compared to inside gain or loss determined under § 864(c)(8)(B) to derive the amount ultimately reportable by the foreign partner as effectively connected income or loss upon the sale or exchange of its partnership interest. Thus, for example, a foreign partner would compare its outside capital gain to its aggregate deemed sale EC capital gain, treating the former as effectively connected gain only to the extent it does not exceed the latter. The proposed regulations provide several examples illustrating the application of new § 864(c)(8). The proposed regulations do not, however, address the corresponding modifications to the withholding rules in § 1446(f), stating only that the latter regulations are to be issued "expeditiously."

d. A victory in the DC Circuit for the taxpayer, but merely a pyrrhic victory (see above) for future, similarly-situated taxpayers. Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner, 926 F.3d 819 (D.C. Cir. 6/11/19), *aff'g* 149 T.C. 63 (7/13/17). The U.S. Court of Appeals for the District of Columbia Circuit, in an opinion by Judge Srinivasan, has upheld the Tax Court's decision that the $4 million of disputed gain at issue in *Grecian Magnesite* before the Tax Court was not effectively connected income by virtue of the U.S. office rule in § 865(e)(2)(A). (The IRS did not appeal the Tax Court's first holding that, pursuant to the general rule of § 865(a), subject to the narrow exception in § 897(g) for U.S. real property interests, income from the sale of a partnership interest by a nonresident is a sale of personal property and therefore foreign-source income.) In reaching its decision affirming the Tax Court, the D.C. Circuit assumed without deciding, as did the Tax Court, that Premier's U.S. office would be attributed to the taxpayer under § 864(c)(5). Further, the D.C. Circuit agreed with the Tax Court that little deference should be given to the IRS's position espoused in Rev. Rul. 91-32, 1991-1 C.B. 107, that gain realized by a foreign partner from the disposition of an interest in a U.S. partnership should be analyzed asset by asset. The IRS made a technical argument that the Tax Court's decision was incorrect under canons of statutory interpretation, but the D.C. relied upon competing canons of statutory interpretation to side with the taxpayer.

E. Inside Basis Adjustments

F. Partnership Audit Rules

G. Miscellaneous

1. Nonowner contributions to the capital of partnerships and LLCs taxed as partnerships are not excludable, and the common law contribution to capital doctrine is on life support if not dead. The 2017 Tax Cuts and Jobs Act, § 13312, amended Code § 118 effective after December 22, 2017, such that nonshareholder contributions to the capital of corporations made by governmental entities or civic groups no longer are excludable from the recipient corporation's gross income. Previously, such capital contributions were nontaxable, and they occasionally were made to incentivize corporations either to locate in particular communities or to acquire or redevelop distressed property in a community (or do both). In addition, the Conference Report accompanying the changes to § 118, along with the cases summarized below, probably leads to the conclusion that similarly-motivated capital contributions to noncorporate entities (i.e., partnerships and LLCs taxed as partnerships) no longer are excludable from gross income (if they ever were), even though such contributions are outside the purview of either old or amended § 118.

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

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

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

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

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

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

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

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

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

c. The Federal Circuit has affirmed the Claims Court's decision that an LLC classified as a tax partnership could not exclude from gross income a cash payment received from the State of New York. Ginsburg v. United States, 922 F.3d 1320 (Fed. Cir. 4/25/19), *aff'g* 136 Fed. Cl. 1 (1/31/18). In an opinion by Judge Wallach, the U.S. Court of Appeals for the Federal Circuit has affirmed the decision of the U.S. Court of Federal Claims granting summary judgment to

government and held that an LLC classified as a partnership had to include in gross income a cash payment received from the State of New York. As a result, the members of the LLC, including the taxpayers in this case, had to include their distributive shares of the payment in gross income. The taxpayer owned 90% of an LLC taxed as a partnership for federal income tax purposes. The taxpayers held 90 percent of the membership interests in an LLC that participated in New York's Brownfield Development Tax Credit program in connection with acquiring an abandoned shoe factory in 2004 and eventually restoring it as a 134-unit residential building by 2011. Under this program, if the credit is fully used by a taxpayer to offset applicable New York state income taxes, the excess of the credit over the amount used against state income taxes is paid to the taxpayer. After certifying that the taxpayers' LLC had complied with the terms of the Brownfield Development Tax Credit program, in 2013 New York paid the taxpayer's LLC approximately $1.8 million in satisfaction of the taxpayer's excess credit amount. The taxpayers took the position on their 2013 federal income tax return that their 90% allocable share of the $1.8 million payment was excludable from gross income as a nontaxable capital contribution to the LLC. Following an audit, the taxpayers paid the underpayment asserted by the IRS of approximately $602,000, filed a refund claim, and then brought a refund action in the Court of Federal Claims, which held that the payment constituted gross income. On appeal, the Federal Circuit first concluded that the funds received were an economic gain over which the taxpayers had complete dominion and therefore constituted gross income under the taxpayers had gross income under *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). The court rejected all of the taxpayer's arguments that the payments were excludable from income, including the arguments that: (1) the payment for the excess amount was a nontaxable return of capital, and (2) the brownfield redevelopment tax credit was "'indistinguishable from . . . inducement payments, rebates, and reimbursements that' have historically been treated as 'not includable in gross income.'"

2. 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 § 754 *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.

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

B. Identified "tax avoidance transactions"

C. Disclosure and Settlement

D. Tax Shelter Penalties

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. Oh goody! Changes to the UBTI rules! The 2017 Tax Cuts and Jobs Act, §§ 13702 and 13703, also made certain changes to the determination of unrelated business taxable income ("UBTI") with respect to tax-exempt organizations. Most tax-exempt organizations are subject

to federal income tax at regular rates (corporate rates for exempt corporations and trust rates for exempt trusts) on net income (i.e., after permissible deductions) from a trade or business, regularly carried on, that is unrelated to the organization's exempt purpose (other than its need for revenue). Exceptions exist for most types of passive, investment income as well as for narrow categories of other types of income (e.g., thrift store sales). *See* §§ 511-514. The rationale behind the changes to the UBIT rules was to put tax-exempt organizations on par with taxable organizations with respect to certain types of compensation and fringe benefits. Because, however, disallowing deductions for fringe benefits such as parking and transportation expenses (which is what the 2017 Tax Cuts and Jobs Act, § 13304(c), did by adding § 274(a)(4)) does not work for exempt organizations which do not normally pay tax, Congress did something weird. Specifically, Congress decided to arbitrarily increase an exempt organization's unrelated business income (even if such income was otherwise zero) by the value of the fringe benefits the organization provides to employees. Sounds like a simple solution, right? *Wrong! See below.*

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

Congress doesn't like using UBI to help fund fringe benefits, so when your organization's highly-compensated employees are pumping iron at the charity's free gym, you can pump up your UBI too. Under new § 512(a)(7), an organization's unrelated business taxable income is increased by the amount of any expenses paid or incurred by the organization that are not deductible because of the limitations of § 274 for (i) qualified transportation fringe benefits (as defined in § 132(f)); (ii) a parking facility used in connection with qualified parking (as defined in § 132(f)(5)(C)); or (iii) any on-premises athletic facility (as defined in § 132(j)(4)(B)). New § 512(a)(7) is effective for amounts paid or incurred after 2017, so affected tax-exempt organizations need to deal with this change immediately. The IRS has granted some relief, though, in the form of Notice 2018-100, 2018-52 I.R.B. 1074 (12/10/18), discussed further below. Moreover, Notice 2018-100 clarifies that with respect to on-premises athletic facilities UBI is increased under § 512(a)(7) only if the benefits provided discriminate in favor of highly-compensated employees.

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

a. A tax law oxymoron: nonprofit trades or businesses. Huh? Notice 2018-67, 2018-36 I.R.B. 409 (8/21/18). Organizations described in §§ 401(a) (pension and retirement plans) and 501(c) (charitable and certain other entities) generally are exempt from federal income taxation. Nevertheless, §§ 511 through 514 impose federal income tax upon the "unrelated business taxable income" ("UBTI") of such organizations including for this purpose state colleges and universities. The principal sources of UBTI are §§ 512 and 513 "unrelated trade or business" gross income (minus deductions properly attributable thereto) and § 514 "unrelated debt-financed income" (minus deductions), including a partner's allocable share of income from a partnership generating UBTI. Prior to TCJA, exempt organizations could aggregate income and losses from unrelated trades or businesses before determining annual UBTI potentially subject to tax. Excess losses (if any) after aggregating all UBTI-related items of an exempt organization created a net operating loss subject to the rules of § 172. [See Reg. § 1.512(a)-1(a) prior to enactment of TCJA. After TCJA, § 172 permits only carryforwards.] Effective for taxable years beginning after 2017, however, TCJA added new § 512(a)(6) to disaggregate unrelated trades or businesses of exempt organizations for purposes of determining UBTI.

Specifically, new § 512(a)(6) provides that for any exempt organization with more than one unrelated trade or business: (1) UBTI must be computed separately (including for purposes of determining any net operating loss deduction) for each such unrelated "trade or business;" and (2) total annual UBTI is equal to (i) the sum of positive UBTI from each such separate "trade or business" minus (ii) the specific $1,000 deduction allowed by § 512(b)(12). Under a special transition rule, unrelated business income net operating losses arising in a taxable year beginning before January 1, 2018 and carried forward to a taxable year beginning on or after such date, are not subject to new § 512(a)(6).

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

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

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

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

- The "interim rule" that permits the aggregation of multiple lines of UBTI from an exempt organization's interest in a single partnership if the partnership meets either a "de minimis test" or a "control test." The de minimis test generally is met if the exempt organization partner holds a 2 percent or less capital and profits interest in a partnership. The control test generally is met if the exempt organization partner holds a 20 percent or less capital interest in a partnership and does

not have "control or influence" over the partnership. Control or influence over a partnership is determined based upon all relevant facts and circumstances. For purposes of determining an exempt organization's percentage interest in a partnership under the interim rule, partnership interests held by disqualified persons (as defined in § 4958), supporting organizations (as defined in § 509(a)(3)), and controlled entities (as defined in § 512(b)(13)(D)) must be considered.

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

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

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

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

c. Never had UBTI or paid estimated taxes thereon? Not to worry, says the IRS. Notice 2018-100, 2018-52 I.R.B. 1074 (12/10/18). Prior to the enactment of § 512(a)(7), many if not most § 501(c)(3) organizations had never reported UBTI or paid any unrelated business income tax ("UBIT") thereon. Organizations that owe UBIT are required to pay estimated taxes or suffer penalties. See IRC § 6655(c) and (d)(1)(A). Furthermore, because these organizations have never paid UBIT, they would not be eligible for the safe harbor exclusion for estimated taxes under § 6655(d)(1) (estimated payments equal to prior year's UBIT). Accordingly, with new § 512(a)(7) catching most tax-exempt organizations off guard, the IRS has decided "in the interest of sound tax administration" (in other words, to prevent another Boston Tea Party) to waive the penalty for failure to make estimated UBIT payments for such exempt organizations. Note, however, the penalty waiver is limited to "tax-exempt organizations that provide qualified transportation fringes (as defined in § 132(f)) and any parking facility used in connection with qualified parking (as defined in §132(f)(5)(C)) to an employee

to the extent that the underpayment of estimated income tax results from enactment of [§§ 13304(c) and 13703 of the 2017 Tax Cuts and Jobs Act]." Furthermore, the relief is available only to a tax-exempt organization that was not required to file a Form 990-T (the UBIT form) for the taxable year immediately preceding the organization's first taxable year ending after December 31, 2017. Notice 2018-100 does not address the possibility of estimated UBIT payments attributable to discriminatory on-premises athletic facilities. To avail themselves of the relief granted by the Notice, exempt organizations must write "Notice 2018-100" on the top of the organization's Form 990-T.

d. Much Ado About Nothing. Congress has repealed with retroactive effect the increase to UBTI for nondeductible fringe benefits provided by tax-exempt organizations. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title III, § 302 of the 2020 Further Consolidated Appropriations Act, repealed Code § 512(a)(7). Under former § 512(a)(7), a tax-exempt organization's unrelated business taxable income was increased by the amount of any expenses paid or incurred by the organization that were not deductible because of the limitations of § 274 for (i) qualified transportation fringe benefits (as defined in § 132(f)); (ii) a parking facility used in connection with qualified parking (as defined in § 132(f)(5)(C)); or (iii) any on-premises athletic facility (as defined in § 132(j)(4)(B)). The repeal is effective retroactively as if the repeal had been part of the 2017 TCJA. In other words, § 512(a)(7) never took effect. Tax-exempt organizations should be entitled to a refund of any UBIT paid pursuant to former § 512(a)(7).

2. Has so-called "dark money" become virtually invisible (except to the IRS, of course)? Rev. Proc. 2018-38, 2018-31 I.R.B. 280 (07/16/18). Oversimplifying a bit for the sake of convenience, since 1969 § 6033(b)(5) has required § 501(c)(3) organizations to disclose on their annual information returns (Forms 990) certain contributions as well as "the names and addresses of [the organization's] substantial contributors" for the year. Section 507(d)(2) defines a "substantial contributor" as any person contributing $5,000 or more to an organization if such amount is greater than 2 percent of the total contributions to the organization during the taxable year. Section 1.6033-2 of the regulations extended this disclosure requirement to other types of organizations exempt under § 501(a), including § 501(c)(4) "social welfare" organizations and § 501(c)(6) "trade associations." In particular, some § 501(c)(4) social welfare organizations have been created and funded to engage in lobbying and political campaign activity that is prohibited to § 501(c)(3) organizations. This use of § 501(c)(4) organizations has been termed "dark money" by some and is controversial. Although the names and addresses of "dark money" contributors were supposed to be redacted on the organization's Form 990 made publicly available by the IRS pursuant to § 6104(b), some inadvertent disclosures have occurred. Reportedly, a few of the largest organizations impacted have been entities affiliated with the National Rifle Association, the U.S. Chamber of Commerce, and Americans for Prosperity, the latter being tied to billionaires Charles and David Koch. *See* R. Rubin, "U.S. Treasury Restricts Donor Disclosure Requirement for Some Nonprofit Groups," Wall St. J. (July 16, 2018). After Rev. Proc. 2018-38, though, substantial contributors' names and addresses are no longer required to be disclosed on a non-(c)(3) organization's annual Form 990. As stated in the revenue procedure, "The IRS does not need personally identifiable information of [such] donors to be reported . . . in order for it to carry out its responsibilities. The requirement to report such information increases compliance costs for some private parties, consumes IRS resources in connection with the redaction of such information, and poses a risk of inadvertent disclosure of information that is not open to public inspection." The reporting changes announced by Rev. Proc. 2018-38 are effective for taxable years ending on or after December 31 2018. Notwithstanding this relief from disclosure granted to § 501(a) organizations other than (c)(3)s, Rev. Proc. 2018-38 states that the affected organizations must maintain donor information in the organization's books and records in case such information is requested by the IRS.

a. ♫♪This little light of mine, I'm gonna let it shine . . ."♪♫ Bullock v. Internal Revenue Service, 401 F.Supp.3d 1144 (D. Mont. 7/30/19). In a suit brought by Governor Stephen Bullock (also a former Democratic candidate for President in 2020), the U.S. District Court for the District of Montana (Judge Morris) set aside Rev. Proc. 2018-38 for failure to comply with the Administrative Procedure Act ("APA"). Governor Bullock had argued that, although the Commissioner has discretion to determine whether the names and addresses of substantial contributors

must be disclosed on annual information returns filed by exempt organizations other than (c)(3)s, the change announced in Rev. Rul. 2018-38 was a new "legislative rule." As such, Treasury and the IRS had to comply with the notice and comment procedures of the APA (which they did not do) before issuing Rev. Proc. 2018-38. Treasury and the IRS maintained that Rev Proc. 2018-38 was merely a "procedural rule," not a "legislative rule," so the APA's notice and comment requirements did not apply. Judge Morris disagreed and sided with Governor Bullock to hold that Treasury and the IRS should have complied with the APA before issuing Rev. Proc. 2018-38.

b. OK, you win for now. We'll go over to the "Darkside" soon. REG-102508-16, Guidance Under Section 6033 Regarding the Reporting Requirements of Exempt Organizations, 84 F.R. 47447 (9/10/19). Apparently believing that Governor Bullock had a valid point, Treasury and the IRS have issued proposed regulations under § 6033 that ultimately will implement the guidance set forth in Rev. Proc. 2018-38: generally, only § 501(c)(3) organizations must disclose the names and addresses of substantial contributors on their annual Form 990 information returns. Although § 501(c)(4) and certain other non-(c)(3) exempt organizations no longer will be required to disclose names and addresses of substantial contributors on their annual information returns once the regulations become final, such organizations nevertheless are required to keep records (which can be requested by the IRS) containing such information. Note: Code § 527 political organizations must continue to report the names and addresses of substantial contributors.

3. The eleven-factor facts and circumstances test for political campaign activity by tax-exempts set forth in Rev. Rul. 2004-6 is neither unconstitutionally vague nor overbroad, at least on its face. Freedom Path, Inc. v. Internal Revenue Service, 120 A.F.T.R. 2d 2017-5125 (N.D. Tex. 7/7/17). In this unreported decision from the U.S. District Court for the Northern District of Texas, Judge Fitzwater upheld Rev. Rul. 2004-6, 2004-1 C.B. 328, as being neither unconstitutionally vague nor overbroad on its face for purposes of determining impermissible political campaign activity by a § 501(c)(4) organization. Rev. Rul. 2004-6 sets forth an eleven-factor facts and circumstances test used by the IRS to determine whether certain activity by tax-exempt § 501(c)(3) or (c)(4) organizations is impermissible political campaign activity. The IRS preliminarily denied exempt § 501(c)(4) status to Freedom Path, Inc. on the basis that its proposed activities were primarily political in nature. Freedom Path then sued Lois Lerner and the IRS before the IRS even issued a final negative determination letter to Freedom Path. The opinion in this case is the fourth ruling issued by Judge Fitzwater in a series of claims made in this ongoing lawsuit against the IRS and former Exempt Organizations Director Lois Lerner alleging that conservative § 501(c)(4) groups had been targeted for denial of tax-exempt status during the 2011-2012 election cycle. The specific issue in this case was whether Rev. Rul. 2004-6 was unconstitutional on its face under either the First Amendment (free speech) or Fifth Amendment (due process) for being vague or overbroad. Judge Fitzwater held that it was not. The next and fifth ruling in this case almost certainly will be whether the eleven-factor test in Rev. Rul. 2004-6 was applied in an unconstitutional manner by the IRS to preliminarily deny § 501(c)(4) exempt status to Freedom Path, Inc. Stay tuned . . . .

a. Meanwhile, prompted by the IRS, the Fifth Circuit had another idea how to resolve the issue of the facial challenge to Rev. Rul. 2004-6. Freedom Path, Inc. v. Internal Revenue Service, 913 F.3d 503 (5th Cir. 1/16/19), vacating and remanding 120 A.F.T.R. 2d 2017-5125 (N.D. Tex. 7/7/17). On appeal of the narrow issue regarding whether Rev. Rul. 2004-6 is unconstitutional on its face, the Fifth Circuit, in an opinion written by Judge Southwick, decided Freedom Path lacked standing to sue. Freedom Path had made the same arguments before the Fifth Circuit as it had made before Judge Fitzwater. Cleverly, though, the IRS argued before the Fifth Circuit that Rev. Rul. 2004-6 technically was not applied to deny Freedom Path's application for exempt status under § 501(c)(4). (The IRS had not made this argument before Judge Fitzwater.) Rather, the IRS pointed out that the facts and circumstances test described in Rev. Rul. 2004-6 was considered by the IRS, along with other authorities, as part of the decision to deny (c)(4) status to Freedom Path, but the actual application of Rev. Rul. 2004-6 by its terms relates to determining an exempt organization's tax liability (if any) under § 527 (political organizations). Furthermore, argued the IRS, Freedom Path has no tax liability under § 527. Thus, the IRS concluded, Rev. Rul. 2004-6 is not the source of the alleged

injury to Freedom Path. The Fifth Circuit agreed with the IRS's analysis and determined that Freedom Path did not have standing because its claim (i.e., denial of (c)(4) status) was not "fairly traceable" to the text of Rev. Rul. 2004-6. Therefore, the Fifth Circuit vacated Judge Fitzwater's opinion (which had considered but rejected Freedom Path's constitutional challenge to Rev. Rul. 2004-6) and remanded the case to be dismissed for lack of jurisdiction. As noted above, Freedom Path's claim that it was unconstitutionally denied (c)(4) status (as opposed to its claim that Rev. Rul. 2004-6 is unconstitutional on its face) remains subject to challenge by Freedom Path and likely will be the next chapter in this story.

B. Charitable Giving

1. It took some time, but finally we "gotcha," says the IRS, in this infamous charitable contribution case involving billionaire and Miami Dolphins' owner Stephen Ross and the University of Michigan. RERI Holdings I, LLC v. Commissioner, 149 T.C. 1 (7/3/17). In a TEFRA case that has gone on for some time and has produced at least one other noteworthy holding (see below), the IRS prevailed in denying a $33 million charitable contribution deduction to a partnership in which Stephen Ross, owner of the Miami Dolphins, was a partner. The property was donated to the University of Michigan, Mr. Ross's alma mater. The partnership had paid only $2.95 million for the property a little over a year prior to its donation. In fact, at some point after the donation the University of Michigan sold the property for only $1.94 million. These facts, of course, displeased the IRS greatly, and the IRS convinced the Tax Court to deny the partnership's charitable contribution deduction on technical grounds (as discussed below). Moreover, contrary to decisions of the Fifth and Ninth Circuits, the Tax Court (Judge Halpern) determined that the partners of the partnership potentially are liable for aggregate gross valuation misstatement penalties of about $11.8 million.

The facts of the case are complicated, but essentially reveal that for tax year 2003 the partnership claimed a $33 million charitable contribution deduction under § 170(a)(1) for a donation to the University of Michigan. The donated property consisted of a remainder interest in a disregarded single-member LLC that the partnership owned and that held underlying real property. On its Form 8283, Noncash Charitable Contributions, the partnership failed to report its "cost or adjusted basis" for the donated property as required by Reg. § 1.170A-13(c)(4)(ii)(E), instead leaving the line on the form completely blank. Judge Halpern ruled that this failure to comply either strictly or substantially with the regulations is fatal to a claimed charitable contribution deduction, thereby denying the deduction in full. Lastly, for purposes of determining potential penalties, the Tax Court held that the correct value of the property at the time of the donation was approximately $3.5 million.

Regarding the IRS's assertion of the 40 percent penalty under § 6662(h) for "gross valuation misstatements" (valuation of 400 percent or more of correct value), the partnership argued that § 6662 should not apply because the $33 million charitable contribution deduction was completely disallowed and hence was not "attributable to" a valuation misstatement. *See, e.g.*, *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990), *rev'g* T.C. Memo. 1988-408; *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990), *aff'g* T.C. Memo. 1988-416. Judge Halpern's opinion, however, relies upon the Tax Court's more recent decision in *AHG Investments, LLC v. Commissioner*, 140 T.C. 73 (2013), in which the court declined to follow *Heasley* and *Gainer*. Judge Halpern noted that both the Fifth and Ninth Circuits have expressed reservations about *Heasley* and *Gainer*, and because any appeal by the partnership (due to its dissolution in 2004) would be to the U.S. Court of Appeals for the Federal Circuit, the Tax Court was free to follow its decision in *AHG Investments*. Judge Halpern then determined that the correct fair market value of the donated property should have been roughly $3.5 million, i.e., $29.5 million less than the value claimed by the partnership. Therefore, subject to partner-level § 6662(e)(2) calculations ($5,000 underpayment threshold per partner), the partners of the partnership potentially are liable for penalties aggregating as much as $11.8 million (40 percent of the $29.5 million valuation overstatement).

- The IRS probably thought it should have won this case previously on a similar technicality. In *RERI Holdings I, LLC v. Commissioner*, 143 T.C. 41 (2014), the IRS had cleverly argued on a summary judgment motion that the partnership's "qualified appraisal" (*see* § 170(f)(11)) of the property was fatally flawed. Specifically, the IRS had argued that although the partnership obtained an

otherwise qualified appraisal, the partnership's appraisal valued a remainder interest in the underlying real property, not the remainder interest in the disregarded single-member LLC that held the real property. The remainder interest in the disregarded single-member LLC was the property the partnership donated to the University of Michigan, not the real property itself. Thus, argued the IRS, the partnership's otherwise qualified appraisal was for *the wrong property* (even though under § 7701 the single-member LLC was completely disregarded for all other tax purposes)! But, in 2014 Judge Halpern did not let the IRS win so easily. Judge Halpern accepted the IRS's argument that a charitable contribution of an interest in a disregarded single-member LLC should be viewed differently (and perhaps valued differently) than a charitable contribution of the underlying asset(s). Judge Halpern so held even while acknowledging that a single-member LLC otherwise is ignored for federal tax purposes. Judge Halpern's opinion relied heavily on the Tax Court's earlier decision in a gift tax case involving a disregarded single-member LLC. *See Pierre v. Commissioner*, 133 T.C. 24 (2009), *supplemented by* T.C. Memo. 2010-106. Nevertheless, perhaps to avoid so-easily granting summary judgment against the taxpayer and in favor of the IRS in 2014, Judge Halpern reasoned that there was an unresolved issue of material fact whether a valuation of the real property held by the partnership's disregarded single-member LLC could "stand proxy" for the otherwise required "qualified appraisal." Surprisingly, though, Judge Halpern's decision in the earlier *RERI* ruling raises the prospect of a disregarded single-member LLC interest being regarded and valued separately for purposes of determining charitable contributions under § 170.

a. Fumble? Touchdown IRS? Game over? Pick your pun, but it might be time for this taxpayer to admit defeat. Fiddlesticks!!! *RERI Holdings I, LLC v. Commissioner*, 924 F.3d 1261 (Fed. Cir. 5/24/19). The Court of Appeals for the Federal Circuit (Judge Ginsburg) has affirmed the holding of the Tax Court that the taxpayer's failure to report its "cost or adjusted basis" for donated property on Form 8283, Noncash Charitable Contributions, as required by Reg. § 1.170A-13(c)(4)(ii)(E), is fatal to the taxpayer's claimed $33 million charitable contribution deduction. The Court of Appeals for the Federal Circuit also upheld the Tax Court's imposition of a 40 percent gross valuation misstatement penalty under § 6662(h) even though the claimed charitable contribution deduction ultimately was disallowed. After summarizing the facts and procedural posture of the case, the Federal Circuit explained that, even assuming for the sake of argument that the requirements of Reg. § 1.170A-13(c)(4)(ii)(E) can be met by substantial compliance as the taxpayer had claimed in the Tax Court and on appeal, the taxpayer had not in fact substantially complied with the regulations because it left a blank line on the Form 8283 instead of providing any information whatsoever as to its cost or adjusted basis in the donated property. The Federal Circuit also rejected all four of the taxpayer's arguments (one of which was new) and upheld the Tax Court's imposition of the 40 percent gross valuation misstatement penalty under § 6662(h). With regard to this latter ruling upholding the Tax Court, the Federal Circuit reasoned as follows. First, the taxpayer argued de novo that the IRS failed to obtain the supervisory approval required under § 6751(b) before imposing a penalty under § 6662. See Chai v. Commissioner, 851 F.3d 190 (2017). The Federal Circuit rejected this new argument by the taxpayer, however, because the argument had not been raised previously in the Tax Court (notwithstanding the fact that Chai had not been decided at the time the taxpayer was before the Tax Court). Responding to the taxpayer's contention that it did not raise the argument in Tax Court because Chai had not been decided and the Tax Court's prior position at the time was that supervisory approval was not required under § 6751(b) until assessment, see Graev v. Commissioner, 147 T.C. 460 (2016) supplemented and overruled in part by Graev v. Commissioner, 149 T.C. 485 (2017), the Federal Circuit wrote: "Fiddlesticks. The fact is that when RERI was before the Tax Court, it 'was free to raise the same, straightforward statutory interpretation argument the taxpayer in Chai made' there." Second, the Federal Circuit agreed with the Tax Court's rejection of the taxpayer's "attributable to" argument which previously had been addressed by Judge Halpern. Third, the Federal Circuit rejected the taxpayer's argument that Judge Halpern failed to properly value the donated property for purposes of determining the gross valuation misstatement penalty. Finally, the Federal Circuit rejected the taxpayer's argument that it had met the "reasonable cause" exception for avoiding the gross valuation misstatement penalty of § 6662(h). Judge Halpern similarly had ruled that the taxpayer did not meet the "reasonable cause" exception; however, Judge Halpern concluded the IRS had met its burden of proof under Rule 142 that reasonable cause was lacking whereas the Federal Circuit reasoned that,

regardless, the taxpayer did not show reasonable cause and did not qualify for the exception irrespective of whether the IRS must show a lack of reasonable cause under Rule 142.

2. Personally evangelizing for "BSDM" — pay attention; we didn't write "BDSM" — doesn't allow you to take charitable contribution deductions for your unreimbursed expenses. Oliveri v. Commissioner, T.C. Memo 2019-57 (5/28/19). Although expenses incurred "for the use of" a charitable organization can be deductible under § 170, the Tax Court held that this taxpayer took things a little too far. (Sometimes you really can't help but wonder, "What were they thinking?" when reading certain Tax Court cases. This is one of those cases.) The taxpayer was a former U.S. Air Force pilot who upon his retirement from the Air Force became very active in the Catholic Church. The taxpayer frequently attended church-related meetings, participated in community outreach efforts, and assisted various church officials. In 1987, the taxpayer was certified as a teacher and trainer for the Catholic Church following his completion of a 16-week Catholic evangelization trainer's program. Since that time, the taxpayer has devoted his life to evangelism on behalf of the Catholic Church. The taxpayer considered all of his contact with the public an opportunity for evangelism, and he would wear a large and visible crucifix at all times. The taxpayer evangelized and discussed his faith with friends, members of his extended family, and members of the religious organization that he founded, The Brothers and Sisters of the Divine Mercy ("BSDM"). (No, we're not kidding. The acronym used by the Tax Court really was "BSDM.") The taxpayer incurred significant expenses in connection with his BSDM and Catholic Church evangelism activities in 2012, including costs for piloting and flying a leased airplane, commercial airfare, other transportation, lodging, meals, gifts for needy individuals and members of BSDM, etc. The taxpayer's 2012 unreimbursed expenses in this regard totaled at least $39,979, all of which he deducted as charitable contributions. None of the taxpayer's activities or expenses, however, were expressly authorized by the Catholic Church, and the Catholic Church did not provide the taxpayer with contemporaneous written acknowledgments for his expenses. After restating the general rule that to be deductible under § 170 unreimbursed expenses must be subject to coordination, supervision, or oversight by a charitable organization, see Van Dusen v. Commissioner, 136 T.C. 515 (2011), the Tax Court (Judge Colvin) had little trouble denying the taxpayer's claimed deductions in this case. The Tax Court reasoned that not only did the unreimbursed expenses fail to meet the Van Dusen standard, but most of the taxpayer's expenses were incurred in whole or in part for personal purposes. Furthermore, with respect to unreimbursed expenses of $250 or more attendant to rendering services on behalf of a charity, a taxpayer must obtain a contemporaneous written acknowledgment to comply with Reg. § 1.170A-13(f)(10). The taxpayer did not, even from BSDM, the organization he founded. Perhaps, though, divine intervention did play a role in this case. The Tax Court held that the IRS could not impose accuracy-related penalties against the taxpayer because prior, written supervisory approval had not been obtained as required by § 6751(b)(1). See *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017); *Graev v. Commissioner*, 149 T.C. 485 (2017).

3. Taxpayers have a greater ability to deduct charitable contributions for relief efforts in areas affected by qualified disasters. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title II, § 204(a) of the 2020 Further Consolidated Appropriations Act, provides special rules for charitable contributions for relief efforts in qualified disaster areas. Normally, the limit that applies to the deduction for most charitable contributions by individuals is 50 percent of the taxpayer's contribution base, which, generally speaking, is adjusted gross income. Lower limits can apply depending on the type of recipient and the type of property contributed. The limit that applies to the deduction for most charitable contributions by corporations generally is 10 percent of taxable income. Contributions that exceed these limits generally can be carried forward five years. The legislation provides that "qualified contributions" by an individual are not subject to the normal limits, and instead are allowed up to the amount by which the taxpayer's contribution base (AGI) exceeds the other charitable contributions the taxpayer makes, i.e., those subject to the normal limit. In effect, this permits individual taxpayers to deduct qualified contributions up to 100 percent of the taxpayer's contribution base (AGI) after taking into account other charitable contributions. For corporations, the limit on qualified contributions is the amount by which the corporation's taxable income exceeds the

corporation's other charitable contributions, i.e., the corporation can deduct qualified contributions up to 100 percent of taxable income after taking into account other charitable contributions. Qualified contributions by an individual or a corporation that that exceed the relevant limit can be carried forward five years. A *qualified contribution* is defined as a charitable contribution (as defined in § 170(c)) that meets three requirements: (1) the contribution must be paid in cash to an organization described in § 170(b)(1)(A) during the period beginning on January 1, 2018, and ending on February 18, 2020 (60 days after the date of enactment), for relief efforts in a qualified disaster area, (2) the taxpayer must obtain from the organization a contemporaneous written acknowledgment that the contribution was used (or will be used) for such relief efforts, and (3) the taxpayer must elect the application of this special rule. For partnerships or S corporations, the election is made separately by each partner or shareholder. The legislation does not specify the manner of making the election. Presumably, taking the deduction on the return will constitute an election.

Several key terms are defined in Division Q, Title II, § 201 of the 2020 Further Consolidated Appropriations Act. These are as follows:

1. The term "*incident period*" with respect to any qualified disaster is the period specified by FEMA as the period during which the disaster occurred, except that the period cannot be treated as beginning before January 1, 2018, or ending after January 19, 2020 (the date that is 30 days after the date of enactment of the legislation).
2. The term "*qualified disaster zone*" is the portion of the qualified disaster area determined by the President to warrant individual or individual and public assistance from the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of the qualified disaster with respect to the qualified disaster area.
3. The term "*qualified disaster area*" is an area with respect to which the President declared a major disaster from January 1, 2018, through February 18, 2020 (the date that is 60 days the date of enactment of the legislation), under section 401 of the Stafford Act if the incident period of the disaster began on or before December 20, 2019 (the date of enactment). To avoid providing double benefits, the legislation excludes the California wildfire disaster area, for which similar relief was provided by the Bipartisan Budget Act of 2018.
4. "The term '*qualified disaster*' means, with respect to any qualified disaster area, the disaster by reason of which a major disaster was declared with respect to such area."

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. In this case a nonprofit corporation is treated the same as a for-profit corporation. Maimonides Medical Center v. United States, 809 F.3d 85 (2d Cir. 12/18/15). In an opinion by Judge Lynch, the Second Circuit held that the lower interest rate that under § 6621(a)(1) applies to a refund for an overpayment of taxes due to a corporation applies to not-for-profit corporations as well as to for-profit corporations.

a. The Sixth Circuit agrees. United States v. Detroit Medical Center, 833 F.3d 671 (6th Cir. 8/12/16). The IRS refunded FICA taxes paid by the plaintiff, a not-for-profit corporation, for periods prior to 4/1/05 following the IRS's ruling that medical residents were eligible for the student exemption from FICA taxes. The IRS paid interest on the employer portion of the FICA taxes at the statutory rate provided by § 6621(a)(1) for corporations (the federal short-term rate plus 2 percentage points, reduced to 0.5 percentage points to the extent the overpayments exceed $10,000). The plaintiff asserted that, because it is a nonprofit corporation, it should not be treated as a corporation for this purpose. Instead, it asserted, it was entitled to interest at the higher statutory rate provided for non-corporate taxpayers (the federal short-term rate plus 3 percentage points). According to the plaintiff, it was entitled to additional interest of approximately $9.1 million. In an opinion by Judge Sutton, the Sixth Circuit held that nonprofit corporations are "corporations" for purposes of determining the rate

of interest on overpayments. Accordingly, the court affirmed the District Court's grant of the government's motion for summary judgment.

b. The Seventh Circuit jumps on the bandwagon. Medical College of Wisconsin Affiliate Hospitals, Inc. v. United States, 854 F.3d 930 (7th Cir. 4/25/17). In a case raising the same issue, the United States Court of Appeals for the Seventh Circuit, in an opinion by Judge Easterbrook, concluded that a nonprofit corporation is entitled to interest on a tax overpayment at the statutory rate provided by § 6621(a)(1) for corporations.

c. The Tenth Circuit jumps on the (now overloaded?) bandwagon. Wichita Center for Graduate Medical Education, Inc. v. United States, 917 F.3d 1221 (10th Cir. 3/7/19). In yet another case raising the same issue, the United States Court of Appeals for the Tenth Circuit, in an opinion by Judge Tymkovich, agreed that a nonprofit corporation is nonetheless a "corporation" for purposes of the lower overpayment rate of interest set forth in § 6621(a)(1).

2. Accuracy-related penalties determined by the IRS's Automated Correspondence Exam system are penalties "automatically calculated through electronic means" and therefore are not subject to the requirement of § 6751(b) that they be approved in writing by a supervisor. Walquist v. Commissioner, 152 T.C. No. 3 (2/25/19). The 2014 federal income tax return filed by the taxpayers, a married couple, reflected wages and other income of $94,114 and a purported offset or deduction of $87,648, labeled as a "Remand for Lawful Money Reduction." They failed to report $1,215 of unemployment compensation reported on Form 1099-G by the State of Minnesota. After taking into account the standard deduction, the taxpayers reported negative taxable income of ($5,731). The IRS's computer document matching system identified the return for examination, which was processed by the IRS's Automated Correspondence Exam (ACE) system. The ACE system employed the IRS's Correspondence Examination Automated Support (CEAS) software, which generated and issued to the taxpayers a Letter 525, General 30-Day Letter. The 30-day letter calculated a proposed deficiency $13,832 and automatically calculated a 20 percent ($2,766.40) accuracy-related penalty pursuant to § 6662(a), (b)(2), and (d)(1)(A) for a substantial understatement of income tax. Following the taxpayers' failure to respond to the 30-day letter, the CEAS program generated a notice of deficiency, in response to which the taxpayers filed what purported to be a petition in the Tax Court. They filed a copy of the notice of deficiency, on each page of which they had written "REFUSAL FOR CAUSE," and attached various documents that set forth arguments commonly made by tax protestors as well as a demand that the Tax Court garnish the wages of the Secretary of the Treasury. Among other issues in the case, the Tax Court (Judge Lauber) addressed whether the accuracy-related penalty calculated by the IRS's CEAS program was subject to the requirement of § 6751(b) 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." The court held that it was not. In Graev v. Commissioner, 149 T.C. No. 23 (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." Section 6751(b)(2), however, provides that supervisory approval is not required for "any addition to tax under section 6651, 6654, or 6655, or" for "any other penalty automatically calculated through electronic means." The penalty in this case, the court concluded, "was determined automatically by a computer software program without the involvement of a human IRS examiner," and therefore was a penalty "automatically calculated through electronic means" within the meaning of § 6751(b)(2)(B). The court noted that its decision is consistent with the IRS's Internal Revenue Manual, which states that substantial understatement penalties determined by the CEAS program (as well as those calculated through the Automated Underreporter program) are exempt from the supervisory approval requirement. The court also noted that its conclusion is consistent with the policy underlying the supervisory approval requirement of § 6751(b), which was enacted as a means of preventing IRS employees from threatening unjustified penalties to encourage settlement. Because the supervisory approval requirement did not apply, the IRS had no burden of production with respect to the penalty.

The court also imposed a penalty of $12,500 on the taxpayers pursuant to § 6673(a)(1) for advancing frivolous positions in their petition and in subsequent proceedings.

- The Tax Court previously had held in *Williams v. Commissioner*, 151 T.C. No. 1 (7/3/18), that the supervisory approval requirement of § 6751(b) does not apply to the Tax Court when it imposes penalties under § 6673(a)(1).

3. The supervisory approval requirement of § 6751(b) "includes no requirement that all potential penalties be initially determined by the same individual nor at the same time," says the Tax Court. Palmolive Building Investors, LLC v. Commissioner, 152 T.C. No. 4 (2/28/19). The taxpayer, a TEFRA partnership, granted in 2004 a conservation easement valued at $257 million on the façade of the Palmolive Building on North Michigan Avenue in Chicago. In a prior opinion, the Tax Court upheld the IRS's disallowance of the taxpayer's charitable contribution deduction on the ground that mortgages on the building were not fully subordinated to the conservation easement and therefore the charitable organization in whose favor the easement was granted was not, as required by relevant regulations, guaranteed the requisite share of proceeds in the event the easement was extinguished. See *Palmolive Building Investors LLC et al. v. Commissioner*, 149 T.C. No. 18 (10/13/17). The remaining issue was whether, in asserting certain penalties, the IRS had complied with the requirement of § 6751(b) 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." During the examination of the partnership return for the year in question, the IRS's examining agent prepared Form 5701 (Notice of Proposed Adjustment) that had two Forms 886A (Explanation of Items) attached to it. One of the Forms 886A proposed and justified a penalty for gross valuation misstatement under § 6662(h)(1) and the other proposed and justified, in the alternative, a 20 percent negligence penalty under § 6662(b)(1). The agent's supervisor signed the Form 5701. The IRS issued a 30-day letter (Letter 1807) inviting the taxpayer to a closing conference to discuss the adjustments. The 30-day letter referenced only the gross valuation misstatement penalty. Subsequently, the IRS issued a 60-day letter (Letter 1827) proposing adjustments and giving the taxpayer 60 days within which to file a protest with IRS Appeals. The 60-day letter had attached to it the Form 5701 and both Forms 886-A, i.e., it referenced both penalties. In IRS Appeals, the Appeals Officer assigned to the case prepared a Form 5402-c (Appeals Transmittal and Case Memo) that had attached to it a proposed Notice of Final Partnership Administrative Adjustment, (FPAA) the last page of which was a Form 886A that asserted both the original penalties and, in the alternative, two additional penalties: a 20 percent penalty for substantial understatement of income tax under § 6662(b)(2) and a 20 percent penalty for substantial valuation misstatement under § 6662(b)(3). The immediate supervisor of the Appeals Officer signed both the Form 5402-c and the proposed FPAA. The Tax Court (Judge Gustafson) held that the IRS had complied with the supervisory approval requirement of § 6751(b). In reaching this conclusion, the court rejected the taxpayer's argument that the requirement had not been met with respect to the additional two penalties asserted by the Appeals Officer. "Section 6751(b)(1) includes no requirement that all potential penalties be initially determined by the same individual nor at the same time." The court also rejected the taxpayer's argument that the supervisory approval requirement had not been met because the IRS had failed to comply with certain provisions of the Internal Revenue Manual regarding documentation of penalty approval in workpapers. The court emphasized that § 6751(b)(1) "does not require written supervisory approval on any particular form" and does not require the signature or written name of the person making the initial determination of the penalty. The taxpayer also argued that the supervisory approval requirement had not been met because the IRS had failed to establish when the initial determinations of the penalties had been made and because the initial 30-day letter received by the taxpayer referred only to the gross valuation misstatement penalty and not to the negligence penalty. The court rejected these arguments as well. The court reasoned that the examining agent and the Appeals Officer each made their initial determinations at the time they solicited their respective supervisors' approval, and their supervisors had given the requested approval in writing.

4. Don't think you can escape the penalty for filing an S corporation return late, even if you are the only shareholder, by requesting an extension of time to file your individual federal income tax return. ATL & Sons Holdings, Inc. v. Commissioner, 152 T.C. No. 8 (3/13/19).

The petitioner in this case was a subchapter S corporation that filed its 2012 return on Form 1120S late. The S corporation failed to request an extension of time to file its return by filing Form 7004. The sole shareholders of the S corporation were Ralph and Cassandra Allen, a married couple, who timely requested an extension of time to file their 2012 federal income tax return and who timely filed the return by the extended due date. The IRS assessed a $2,340 penalty against the S corporation pursuant to § 6699 for the late filing of its return. The assessment appeared on the S corporation's account transcript with transaction code 166, which indicated that it was a computer-generated assessment of a delinquency penalty. The S corporation had made an unspecified overpayment for 2013, which the IRS credited against the 2012 penalty. The IRS issued a final notice of intent to levy for the balance of the 2012 penalty, in response to which the S corporation requested a collection due process hearing. Following the CDP hearing, which the Allens missed but for which they submitted some additional information, the IRS settlement officer upheld the proposed collection action and the S corporation brought this challenge in the Tax Court. The Tax Court (Judge Gustafson) held that the settlement officer had not abused her discretion in upholding the proposed collection action and granted the IRS's motion for summary judgment. The court noted than an S corporation is an entity separate from its shareholders and is required to file its own return and to request its own extension of time to file the return. The court rejected the S corporation's argument that the penalty should be abated because the IRS had agreed to excuse the penalty under similar circumstances in a different year. The court also disagreed with the S corporation's position that it had a good faith, reasonable cause defense to the penalty because it had only two shareholders who were aware of the S corporation's loss for the year and that no harm had resulted from the late filing. "Section 6999 does not include a condition of harm before the penalty is imposed; it simply imposes a penalty when the filing is late (without reasonable cause)." The court also held that the late-filing penalty of § 6699 was not subject to the requirement of § 6751(b) 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." Section 6751(b)(2) provides that supervisory approval is not required for "any addition to tax under section 6651, 6654, or 6655, or" for "any other penalty automatically calculated through electronic means." The court held that the § 6699 penalty is a "penalty automatically calculated through electronic means" and therefore is not subject to the § 6751(b) supervisory approval requirement. The court rejected the taxpayers' argument that, because the penalty in question is subject to a good faith, reasonable cause defense, it is not a penalty that is "automatically calculated." "The possibility of such a defense does not change the fact that the penalty itself is 'automatically calculated.'" Regarding the IRS's crediting of the S corporation's 2013 overpayment against the 2012 § 6699 penalty, the court held that the IRS's action had not violated § 6330(e)(1), which prohibits a levy before the conclusion of a CDP hearing. Although that provision prohibits collection by levy, "[n]othing in section 6330 prohibits the IRS from engaging in other nonlevy collection actions, including offsetting payments from other periods, as the IRS did in this instance."

5. No addition to tax under § 6654 will be made for farmers and fisherman for failure to make estimated income tax payments for 2018 if they file their 2018 returns and pay the total tax due by April 15, 2019 (April 17 for those in Maine and Massachusetts). Notice 2019-17, I.R.B. 907 (2/28/19). Under § 6654, individuals are required to make advance payments of their estimated income tax liability. Normally, individuals are required to make these payments in equal quarterly installments. Section 6654(a) imposes an addition to tax for failure to pay a sufficient amount of estimated income tax. Those who qualify as farmers or fishermen (generally, those for whom two-thirds of gross income is from farming or fishing) are subject to special rules under which they make only one payment, due on January 15, 2019, for the 2018 tax year, but no addition to tax is imposed for 2018 if a farmer or fisherman files a 2018 return and pays the tax shown due on the return by March 1, 2019. Because of the magnitude of the changes enacted as part of the 2017 Tax Cuts and Jobs Act and the resulting difficulty farmers and fishermen encountered in estimating their income tax liability for 2018, the IRS has waived the addition to tax of § 6654 for a qualifying farmer or fisherman who files his or her 2018 income tax return and pays in full any tax due by April 15, 2019 (or by April 17, 2019, for those taxpayers who live in Maine or Massachusetts). To request this waiver, farmers and fishermen must attach Form 2210-F, Underpayment of Estimated Tax by Farmers and Fishermen, to

their 2018 tax return, which the taxpayer can do whether the return is filed electronically or on paper. The notice provides that a taxpayer should enter his or her name and identifying number at the top of the form, and should check the waiver box (Part I, Box A). The rest of the form should be left blank.

6. No addition to tax under § 6654 will be made for failure to make estimated income tax payments if total withholding and estimated tax payments exceed 80 percent of tax shown due on the 2018 return. Notice 2019-25, 2019-15 I.R.B. 942 (3/22/19). Under § 6654, individuals are required to make advance payments of their income tax liability either through withholding or quarterly estimated tax payments. Section 6654(a) imposes an addition to tax for failure to pay a sufficient amount of estimated income tax. No addition to tax is imposed if an individual makes payments equal to the lesser of (1) 90 percent of the tax shown on the return for the taxable year, or (2) 100 percent of the tax shown on the taxpayer's return for the preceding taxable year (110 percent if the individual's adjusted gross income on the previous year's return exceeded $150,000), as long as the preceding taxable year was a full twelve months. Because of the magnitude of the changes enacted as part of the 2017 Tax Cuts and Jobs Act and the resulting difficulty taxpayers encountered in estimating their income tax liability for 2018, the IRS previously issued Notice 2019-11, 2019-5 I.R.B. 430 (1/16/19), which waived any addition to tax under § 6654 for an individual whose total withholding and estimated tax payments made on or before January 15, 2019, equal or exceed 85 percent of the tax shown on that individual's 2018 return. In this notice, the IRS has reduced this percentage to 80 percent. Accordingly, no addition to tax under § 6654 will be made with respect to an individual whose total withholding and estimated tax payments made on or before January 15, 2019, equal or exceed 80 percent of the tax shown on that individual's 2018 return. To request this waiver, an individual must file Form 2210, Underpayment of Estimated Tax by Individuals, Estates, and Trusts, with his or her 2018 income tax return. The form can be filed with a return filed electronically or on paper. The notice provides further instructions regarding completion of Form 2210. Taxpayers who are eligible for a waiver and who already have paid the addition to tax can seek a refund by filing Form 843, Claim for Refund and Request for Abatement and including the statement "80% Waiver of estimated tax penalty" on line 7. This notice supersedes Notice 2019-11.

7. Wait a minute, I thought we had a deal?! The IRS can assess and collect the full amount of restitution ordered in a criminal proceeding if the restitution is due immediately, even if the U.S. District Court that ordered it set a schedule of payments. Carpenter v. Commissioner, 152 T.C. No. 12 (4/18/19). The taxpayer agreed to plead guilty in U.S. District Court to two counts of willfully making and subscribing to a false federal income tax return in violation of § 7206(1) and was sentenced to 27 months in prison and ordered to pay to the IRS restitution of $507,995. According to the District Court's order, "the restitution was 'due and payable immediately' and … 'if … [petitioner] can't pay' the entire amount of restitution, he must pay $100 per month beginning 60 days after his release from imprisonment … [and] 'continue making payments until the monies are repaid.'" Following his release from prison in May 2016, the taxpayer complied with this payment schedule. Pursuant to § 6201(4), the IRS assessed the full amount of restitution that had been ordered. The assessment occurred in January 2016, apparently while the taxpayer was still in prison. The IRS subsequently sent a final notice of intent to levy, which indicated that he owed approximately $760,000. This represented the restitution assessed plus interest and penalties. The IRS also filed a notice of federal tax lien. In response, the taxpayer requested a collection due process hearing. He initially indicated that Social Security disability benefits were his only source of income and requested collection alternatives. When the IRS informed him that he was ineligible for collection alternatives because he had failed to file returns for 2011 through 2015, he responded that he had mistakenly requested collection alternatives and that the IRS had no authority to collect because it had not issued a notice of deficiency. Following the CDP hearing, the IRS Appeals Division issued notices of determination upholding the collection action and the taxpayer sought review of the notices of determination in the Tax Court. The Tax Court (Judge Cohen) held that IRS Appeals did not abuse its discretion in sustaining the collection action. In reaching this conclusion, the court considered two issues. *First,* the court rejected the taxpayer's argument that § 6201(4) does not authorize the IRS to

exercise administrative collection powers without obtaining a further order from the sentencing court. Section 6201(4) provides in part:

> A. The Secretary shall assess and collect the amount of restitution under an order pursuant to section 3556 of title 18, United States Code, for failure to pay any tax imposed under this title in the same manner as if such amount were such tax.
>
> B. An assessment of an amount of restitution under an order described in subparagraph (A) shall not be made before all appeals of such order are concluded and the right to make all such appeals has expired.

These provisions, the court reasoned, "indicate[] that Congress intended to grant the Secretary collection authority that is independent from title 18 and the underlying criminal procedures." *Second*, the court rejected the taxpayer's argument that the payment schedule set forth by the sentencing court limited the amount that the IRS could collect. The court distinguished between restitution due immediately with a schedule of payments, such as in the taxpayer's case, and restitution that the sentencing court expressly declines to order as due immediately. Only in the latter situation, the court reasoned, would the IRS be precluded from collecting more than the amounts due under the payment schedule. The court concluded that, unless the sentencing court expressly declines to order restitution payable immediately, the court's judgment imposes an immediate obligation on the defendant to pay the restitution. In this case, the court explained, the sentencing court did not decline to order the restitution as payable immediately, and therefore the IRS could assess and collect the entire amount owed despite the schedule of payments established by the sentencing court.

- The IRS conceded and abated the assessed interest and the additions to tax for late payment based on the Tax Court's decision in *Klein v. Commissioner*, 149 T.C. 341 (2017), in which the court held that the language of § 6201(4)(A) makes clear that "[t]he amount of restitution is not a 'tax imposed by' title 26"and that an assessment of restitution therefore does not trigger interest under § 6601(a) or an addition to tax for late payment under § 6651(a)(3).

- In *Muncy v. Commissioner*, T.C. Memo. 2017-83 (5/17/17), the Tax Court similarly examined the language in § 6201(4) and concluded that the amount of any deficiency (as defined in § 6211(a)) for a tax year is not reduced by any criminal restitution paid. In that decision, the court noted that "[a]ny amount paid to the IRS as restitution for taxes owed must be deducted from any civil judgment the IRS obtains to collect the same tax deficiency."

8. Sending one frivolous amended Form 1040X and later sending six photocopies of the same amended Form 1040X results in only one $5,000 frivilous return penalty, not six more. Kestin v. Commissioner, 153 T.C. No. 2 (8/29/19). After correctly reporting her wages as includible in gross income on her initial federal income tax return on Form 1040, the taxpayer submitted a frivilous amended return on Form 1040X in which she reported no tax due on her wage income. The IRS responded with Letter 3176C inviting the taxpayer to correct the Form 1040X to avoid a $5,000 frivilous filing penalty under § 6702(a). In response, the taxpayer sent six separate letters to varying branches of the IRS each contaning a photocopy of her initial Form 1040X. This resulted in the IRS imposing six additonal $5,000 frivilous filing penalties. Upon her request, the IRS granted the taxpayer a collection due process (CDP) hearing, following which the IRS issued a notice of determination (NOD) sustaining the imposition of all seven penalties. Dissatisfied with her outcome, the taxpayer petitioned the Tax Court pro se challenging the income tax and the six additional $5,000 penalties imposed based on the photocopies of the amended return that she had sent to the IRS. Judge Gustafson quickly rejected as frivilous the taxpayer's claim that her wages were not includible in income and focused on whether the six additional frivolous filing penalties under § 6702(a) were warranted. The court quoted from it recent decision in *Gregory v. Commissioner*, 152 T.C. No. 7 (3/13/19), in which the court had explained:

> Under what is commonly called the Beard test, for example, a return must meet the following criteria: "First, there must be sufficient data to calculate tax liability; second, the document must purport to be a return; third, there must be an honest and reasonable

> attempt to satisfy the requirements of the tax law; and fourth, the taxpayer must execute the return under penalties of perjury." [quoting *Beard v. Commissioner*, 82 T.C. 766, 777 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986).]

If a document does not constitute a "return" under the *Beard* test, the document might fail to trigger various results that follow from the filing of a return. For example, a document that is not a return does not start the running of the limitations period on assessment of tax. The court held that the taxpayer's originally filed Form 1040X was not a return under the *Beard* test because it was not an "honest and reasonable attempt to satisfy the requirements of the tax law" under the third element of *Beard*. Nevertheless, according to the court, the frivolous filing penalty of § 6702(a) is imposed when a person files "what purports to be a return," and because the taxpayer's original Form 1040X purported to be a return and met the other conditions set forth in § 6702(a), the IRS had correctly imposed the frivolous filing penalty with respect to this document. The court then addressed whether any of the six photocopies of the original Form 1040X "purported to be a return" within the meaning of § 6702(a). The court concluded that none of the copies purported to be a return. The court distinguished its holding in *Whitaker v. Commissioner*, T.C. Memo. 2017-192, which upheld two § 6702(a) frivolous filing penalties when the taxpayer submitted two sequential Forms 1040. Each of the two Forms 1040 in *Whitaker* bore the taxpayer's original signature and each had different attachments. Unlike the returns submitted in *Whitaker*, the taxpayer in this case had submitted only photocopies of her returns, none of which contained an original signature and all of which were plainly marked or referenced as copies. These distinctions were sufficient for the court to hold that the photocopies did not "purport[] to be a return" and therefore were not subject to penalties under § 6702(a). The opinion does include a notable caveat indicating that not all copies of returns are immune from a § 6702(a) penalty. The court suggested that it could not rule out the possibility that a frivolous filing penalty would be upheld if, in response to an IRS notice that no return is on file, a taxpayer were to submit a photocopy of a return that the taxpayer alleges to have filed previously. The court also rejected the taxpayer's arguments that the IRS was precluded from imposing the penalties by § 6751(b). Section 6751(b) requires 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." Specifically, the court held that the Letters 3176C sent by the IRS inviting the taxpayer to correct her Form 1040X were not unapproved initial determinations of the penalties. The court also rejected the taxpayer's challenges to the validity of the notice of federal tax lien and the CDP notice sent by the IRS.

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

1. ♪♫If you want my love, leave your name and address …♫♪ A notice of deficiency mailed to the address on the taxpayers' tax return was mailed to the taxpayers' last known address despite their filing of a power of attorney and a request for an extension using their new address. Gregory v. Commissioner, 152 T.C. No. 7 (3/13/19). Section 6212(b)(1) provides that a notice of deficiency in respect of a tax imposed by subtitle A shall be sufficient if "mailed to the taxpayer at his last known address." For this purpose, a taxpayer's last known address is "the address that appears on the taxpayer's most recently filed and properly processed Federal tax return, unless the Internal Revenue Service (IRS) is given clear and concise notification of a different address". Reg. § 301.6212-2(a). The taxpayers in this case, a married couple, moved from Jersey City, New Jersey to Rutherford, New Jersey, on June 30, 2015. They filed their 2014 federal income tax return on October 15, 2015. The return incorrectly reflected their old, Jersey City address. In November 2015, a power of attorney on Form 2848 was submitted to the IRS that had their new, Rutherford address. In April 2016, they filed a request for an automatic extension of time to file their 2015 federal income tax return on Form 4868 that also had their new, Rutherford address. The IRS sent a notice of deficiency with respect to tax year 2014 by certified mail to the taxpayers' old, Jersey City address on October 13, 2016. The U.S. Postal Service returned the notice of deficiency to the IRS as unclaimed; the taxpayers never received it. They first became aware of the notice of deficiency on January 17, 2017, and, in

response, filed a petition in the Tax Court that same day. The IRS moved to dismiss for lack of jurisdiction because the taxpayers had filed their petition late (outside the 90-day time period of § 6213(a)), and the taxpayers moved to dismiss for lack of jurisdiction on the ground that the petition had not been mailed to their last known address and therefore was invalid. The Tax Court (Judge Buch) held that the notice of deficiency had been mailed to the taxpayers' last known address and granted the government's motion to dismiss. The court first reasoned that neither the Form 2848 nor the Form 4868 submitted by the taxpayers was a "return" within the meaning of the last known address rule of Reg. § 301.6212-2(a). These forms, the court reasoned, are not returns under the four-part test of *Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986). Further, the court explained, Reg. § 301.6212-2(a) provides that additional information on what constitutes a return for purposes of the last known address rule can be found in procedures published by the IRS, and Rev. Proc. 2010-16, 2010-19 I.R.B. 664, specifically provides that Forms 2848 and 4868 are not returns for this purpose. The court next concluded that the Forms 2848 and 4868 submitted by the taxpayers had not provided the IRS with clear and concise notification of their new address. The instructions to both forms, the court reasoned, explicitly provide that the forms will not update a taxpayer's address of record with the IRS. That these forms do not constitute clear and concise notification of a new address, the court explained, is implicit in Rev. Proc. 2010-16, which provides that Forms 2848 and 4868 are not returns and that they "will not be used by the IRS to update the taxpayer's address of record." Finally, the court distinguished earlier decisions holding that a Form 2848 filed with the IRS does give clear and concise notification of a new address. See *Hunter v. Commissioner*, T.C. Memo. 2004-81; *Expanding Envelope & Folder Corp. v. Shotz*, 385 F.2d 402 (3d Cir. 1997). The court reasoned that these decisions were based on prior versions of Form 2848 and that "[s]ince 2004 the Commissioner has issued clear guidance informing taxpayers of what actions will and will not change their last known address with the Commissioner."

- The taxpayers, represented by the Legal Services Center of Harvard Law School, have appealed this decision to the U.S. Court of Appeals for the Third Circuit, the same court that held in *Expanding Envelope & Folder Corp.* that a prior version of Form 2848 did provide clear and concise notification of a taxpayer's new address. Stay tuned.

E. Statute of Limitations

1. Shouldn't the limitations periods on seeking tax refunds be simpler? Another case in which a taxpayer loses the ability to obtain a refund because of a limit on the amount of tax recoverable. Borenstein v. Commissioner, 149 T.C. No. 10 (8/30/17). The taxpayer filed a timely extension request for her 2012 federal income tax return and paid a total of $112,000 towards her 2012 federal tax liability. All of her payments, which she made through estimated tax payments and a payment with her extension request, were deemed to be made on April 15, 2013. She did not file her 2012 return until August 29, 2015, after she had received a notice of deficiency for 2012. Her return reflected a tax liability of $79,559, which the IRS agreed was correct. Thus, she had overpaid her 2012 federal tax liability by $38,447. In response to the notice of deficiency, the taxpayer filed a petition in the Tax Court. The issue before the court was whether the taxpayer was entitled to a credit or refund of the overpayment. The Tax Court (Judge Lauber) held that she was not. Under § 6512(b)(1), the Tax Court has jurisdiction to determine an overpayment if it has jurisdiction by virtue of a notice of deficiency. In this case, the court had deficiency jurisdiction because the IRS had issued a notice of deficiency and the taxpayer had filed a timely petition. Section 6512(b)(3), however, imposes a limit on the amount of tax that can be refunded. This provision states that only the portion of the tax paid within one of three specific time periods is allowed as a credit or refund. The parties agreed that the relevant period was that set forth in § 6512(b)(3)(B), which refers to tax paid

> within the period which would be applicable under section 6511(b)(2), (c), or (d), if on the date of the mailing of the notice of deficiency a claim had been filed (whether or not filed) stating the grounds upon which the Tax Court finds that there is an overpayment.

In other words, the court must treat the taxpayer as having filed a hypothetical claim for refund on the date the notice of deficiency was mailed. The question is what amount of tax the taxpayer could have recovered through this hypothetical refund claim taking into account the limits of § 6511(b)(2), (c), or (d). Of these, only § 6511(b)(2) was relevant. This provision states that a taxpayer can recover tax paid within either a two-year or a three-year period ending on the date the taxpayer filed the claim for refund. The three-year look-back period applies when the taxpayer files the refund claim "within 3 years from the time the return was filed." The two-year look-back period applies in all other cases. In this case, the court reasoned, § 6512(b)(3)(B) treats the hypothetical refund claim as having been filed on June 19, 2015, the date on which the notice of deficiency was mailed. This was *before* the taxpayer had filed her return for the year. Accordingly, the court held, the hypothetical refund claim could not be regarded as having been filed "within 3 years from the time the return was filed," and therefore the amount of tax recoverable was limited to the portion paid within the two-year period preceding June 19, 2015. All of the tax in question was deemed paid on April 15, 2013, and therefore the taxpayer was not entitled to a refund of any of the tax paid.

In reaching this conclusion, the court rejected arguments made by the taxpayer and by the Philip C. Cook Low-Income Taxpayer Clinic at the Georgia State University College of Law and the Harvard Federal Tax Clinic as amici curiae. They argued that a three-year look-back period applied by virtue of the final sentence of § 6512(b)(3), which states:

> [W]here the date of the mailing of the notice of deficiency is during the third year after the due date (with extensions) for filing the return of tax and no return was filed before such date, the applicable period under subsections (a) and (b)(2) of section 6511 shall be 3 years.

Congress added this flush language to the statute to overturn legislatively the U.S. Supreme Court's decision in *Commissioner v. Lundy*, 516 U.S. 235 (1996), in which the Court had held that, when a taxpayer has not filed a return, only a two-year look back period (not a two- or three-year, whichever is later, look back period) applies. The Tax Court agreed with the IRS that the parenthetical expression "(with extensions)" in the flush language of § 6512(b)(3) modifies the term "due date." The extended due date was October 15, 2013. The court reasoned that "the third year" referred to in § 6512(b)(3)(B) began on October 15, 2015. The IRS mailed the notice of deficiency on June 19, 2015, which was, the court concluded, during the second year after the extended due date, not the third year. Accordingly, the flush language of § 6512(b)(3), in the Tax Court's view, did not trigger a three-year look-back period. In reaching this conclusion, the court rejected the argument of the amici curiae that the IRS's interpretation of the statute created a six-month jurisdictional "black hole" into which the taxpayer's refund claim disappeared. That turn of phrase apparently resonated with the Second Circuit on appeal, as explained below.

a. The Second Circuit has reversed the Tax Court's decision. Borenstein v. Commissioner, 919 F.3d 746 (2nd Cir. 4/2/19) *rev'g* 149 T.C. No. 10 (8/30/17). The Second Circuit (Judge Jacobs) has reversed the Tax Court's decision and held that the parenthetical expression "(with extensions)" in the flush language of § 6512(b)(3) does not create a six-month "black hole" for jurisdiction regarding refund claims asserted in the Tax Court. Instead, according to the court, the "(with extensions)" language modifies the phrase "third year after the due date." This interpretation has the effect of adding six months to the three-year look-back period that ended on June 19, 2015, the date on which the IRS mailed the notice of deficiency. A look-back period of three years and six months that ends on June 19, 2015, extends back to December 19, 2012. All of the tax in question was deemed paid on April 15, 2013, which was well within the look-back period. Accordingly, the Tax Court could order a refund of the taxpayer's overpayment with respect to 2012. Judge Jacobs reasoned that such an interpretation of the statutory language was consistent with Congressional intent in overturning *Lundy* and also was supported by the longstanding canon of statutory construction that ambiguities must be resolved in favor of taxpayers and against the government.

- On appeal, the Philip C. Cook Low-Income Taxpayer Clinic at the Georgia State University College of Law and the Harvard Federal Tax Clinic filed briefs in support of the taxpayer's position as amici curiae.

2. The common-law mailbox rule has been displaced by regulations, says the Ninth Circuit. Baldwin v. United States, 921 F.3d 836 (9th Cir. 4/16/19). The taxpayers, a married couple, filed a return for 2007 that reflected a net operating loss. They wished to carry this loss back to 2005 and, under the relevant statutory provisions (§ 6511(b)(1), (d)(2)(A)), in order to obtain a refund of taxes paid with respect to 2005, were required to file a claim for refund by October 5, 2011. The taxpayers asserted that they had filed an amended return seeking a refund for 2005 in June 2011. The IRS, however, never received that amended return. The IRS did receive an amended return for 2005 from the taxpayers in 2013, after the limitations period for seeking a refund had expired, and the IRS therefore denied their refund claim. The taxpayers brought this action for a refund in the U.S. District Court. Under § 7422(a), the jurisdiction of both U.S. District Courts and the U.S. Court of Federal Claims to hear tax refund actions is limited to those cases in which the taxpayer has "duly filed" a claim for refund with the IRS. The issue in this case was how the taxpayers could prove that they had filed the necessary timely refund claim. Under the common-law mailbox rule developed and applied by some courts,

> proof of proper mailing—including by testimonial or circumstantial evidence—gives rise to a rebuttable presumption that the document was physically delivered to the addressee in the time such a mailing would ordinarily take to arrive.

At trial, the taxpayers introduced the testimony of two of their employees, who testified that they had deposited the amended 2005 return in the mail at the post office in Hartford, Connecticut, on June 21, 2011. The District Court credited the testimony of the two employees, applied the common-law mailbox rule, and held that the taxpayers were entitled to a refund of approximately $167,000 plus litigation costs of $25,000. In an opinion by Judge Watford, the U.S. Court of Appeals for the Ninth Circuit reversed. The common-law mailbox rule, the court held, has been displaced by § 7502. Under § 7502(a), the postmark stamped on the cover in which a return or claim is mailed is deemed to be the date of delivery if the return or claim (1) is deposited in the mail in the United States within the time prescribed for filing in a properly addressed, postage prepaid envelope or other appropriate wrapper and bears a postmark date that falls within the time prescribed for filing, and (2) is delivered by United States mail after the prescribed time for filing to the agency with which it is required to be filed. The statute also provides that, if the return or claim is mailed by United States registered mail, the date of registration is treated as the postmark date and the registration is prima facie evidence that the return or claim was delivered to the agency to which it was addressed. Section 7502(c)(2) authorizes the Secretary of the Treasury to issue regulations providing the same treatment of returns or claims sent by certified mail, which Treasury and the IRS have done. *See* Reg. § 301.7502-1(c)(2). Section 301.7502-1(e)(2)(i) of the regulations further provides that, except for direct proof of actual delivery, proof of proper use of registered or certified mail (or a designated private delivery service) is the *exclusive means* to establish prima facie evidence of delivery and that "[n]o other evidence of a postmark or of mailing will be prima facie evidence of delivery or raise a presumption that the document was delivered." The Ninth Circuit assessed the validity of the regulation by applying the two-step analysis of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). The court concluded in *Chevron* step one that the statute, § 7502, is silent as to whether it displaces the common-law mailbox rule with respect to items sent by regular mail, and in step two that Reg. § 301.7502-1(e)(2)(i) is a permissible interpretation of the statute. Accordingly, the court deferred to the regulatory interpretation of the statute and held that, because § 7502 displaces the common-law mailbox rule, the taxpayers could not rely on the testimony of their employees to raise a presumption that their refund claim was delivered.

- The Ninth Circuit previously had held in *Anderson v. United States*, 966 F.2d 487 (9th Cir. 1992), that § 7502 did not displace the common-law mailbox rule. Despite that prior decision, the court upheld the validity of the regulation by applying the rule of *National Cable & Telecomm. Association v. Brand X Internet Services*, 545 U.S. 967 (2005), which held that a court's prior judicial construction of a statute trumps an agency construction that is entitled to *Chevron* deference only if the

prior court decision holds that its construction follows from the unambiguous terms of the statute and leaves no room for agency discretion. The Ninth Circuit's decision in *Anderson* did not express such a holding. Prior to Treasury's issuance of Reg. § 301.7502-1(e)(2)(i), other federal courts of appeal had split on the issue whether § 7502 displaced the common-law mailbox rule. It seems likely that, if the issue arises in these courts with respect to a year subject to the regulation, they will follow the Ninth Circuit in giving *Chevron* deference to the regulation.

3. The taxpayers missed an opportunity to challenge the Tax Court's decision in Allen v. Commissioner, which held that the fraud exception to the three-year limitations period on assessment is triggered by a return preparer's fraudulent intent. Finnegan v. Commissioner, 962 F.3d 1261 (11th Cir. 6/11/19), *aff'g* T.C. Memo. 2016-118 (6/16/16). Generally, under § 6501(a), the IRS must assess additional tax within three years after the return for the year in question is filed. Before assessing additional tax, the IRS generally must issue a notice of deficiency, which provides the taxpayer with ninety days within which to file a petition in the Tax Court. In this case, the IRS issued a notice of deficiency with respect to the returns of the taxpayers, a married couple, for the years 1994 through 2001 more than three years after the returns were filed. The IRS argued that the notice of deficiency was timely under the fraud exception of § 6501(c)(1), which provides that tax may be assessed at any time "[i]n the case of a false or fraudulent return with the intent to evade tax." The IRS's theory was that the taxpayers' return preparer had filed false or fraudulent returns for the taxpayers. Their returns included inappropriate items such as losses from a partnership of which they had never heard. According to the court, the taxpayers "apparently were oblivious" to the inappropriate items on their returns. An IRS investigation of the return preparer revealed that he and his associates had filed 750 to 800 fraudulent returns every year for eleven years. The return preparer was indicted and pled guilty to conspiring to defraud the United States and to interfering with the administration of the internal revenue laws. The IRS relied on *Allen v. Commissioner*, 128 T.C. 37 (2007), in which the court had held that "[n]othing in the plain meaning of the statute [§ 6501(c)(1)] suggests the limitations period is extended only in the case of the taxpayer's fraud. The statute keys the extension to the fraudulent nature of the return, not to the identity of the perpetrator of the fraud." At trial in the Tax Court, the IRS introduced prior testimony of the return preparer in which the preparer stated that every return he prepared during the relevant period had been fraudulent. The IRS also presented an affidavit of the return preparer in which he swore that he had knowingly prepared fraudulent returns for the taxpayers. The taxpayers conceded at trial that, if their returns were fraudulent, then pursuant to § 6501(c)(1) the IRS could assess tax at any time. The Tax Court (Judge Wells) held that the fraud exception was triggered and ruled in favor of the IRS. With the assistance of new counsel, the taxpayers filed a motion for reconsideration and argued for the first time that the fraudulent intent of a return preparer (rather than of the taxpayer) cannot trigger the fraud exception. In other words, the taxpayers asked the Tax Court to reconsider its decision in *Allen*. The Tax Court declined to consider this argument because it had been raised for the first time in the taxpayers' motion for reconsideration. In an opinion by Judge Tjoflat, the U.S. Court of Appeals for the Eleventh Circuit affirmed the Tax Court's decision. The taxpayers argued that they had not waived their challenge of the *Allen* decision because the issue of whether a statute of limitations applies is not waivable and because the Tax Court had actually considered their challenge and issued a decision. The Eleventh Circuit rejected these arguments and also declined to exercise its discretion to consider an issue raised for the first time on appeal. The Eleventh Circuit also rejected the taxpayers' challenge to the Tax Court's admission into evidence of the return preparer's prior testimony concerning his preparation of fraudulent returns and his affidavit regarding preparation of the taxpayers' returns. The Tax Court had concluded that these statements qualified for the statement-against-interest exception to the hearsay rule and the Eleventh Circuit agreed.

4. A mandatory 60-day extension of certain deadlines for those adffected by federally delcared disasters. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title II, § 205 of the 2020 Further Consolidated Appropriations Act, provides a mandatory 60-day extention of certain deadlines for those affected by federally declared natural disasters. Prior to the legislation, § 7508A(a) authorized the Secretary of the Treasury to specify a

period of time of up to one year that is disregarded in determining an affected taxpayer's compliance with deadlines such as those for filing returns and paying tax, an affected taxpayer's liability for interest and penalties, and an affected taxpayer's entitlement to a credit or refund. The legislation adds new § 7508A(d), which provides a mandatory 60-day extension for qualified taxpayers. A qualified taxpayer is defined to include those whose principal residence or principal place of business (other than performing services as an employee) is located in a disaster area, relief workers working for recongnized government or philanthropic organizations to assist in a disaster area, those whose records are are located in a disaster area, and those visiting a disaster area who are killed or injured as a result of the disaster. For this purpose, the term "disaster area" is defined in § 165(i)(5), which generally defines a disaster area as any area determined to warrant assistance by reason of any disaster determined by the President to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

F. Liens and Collections

1. ♪♫You say $19.5 million, I say $12,603. Let's call the whole thing off.♫♪ We don't see many taxpayer victories in the Tax Court following a collection due process hearing, but this case is one of them. Campbell v. Commissioner, T.C. Memo. 2019-4 (2/4/19). In response to a notice of federal tax lien and a final notice of intent to levy with respect to $1.2 million of unpaid tax liability and an accuracy-related penalty for 2001, the taxpayer requested a collection due process hearing. Following the CDP hearing, the IRS issued a notice of determination upholding the proposed collection action. The taxpayer sought review of the notice of determination by filing a petition in the Tax Court. In response to motions for summary judgment by the IRS, the Tax Court twice remanded the case to the IRS Appeals Office for supplemental CDP hearings. In the first supplemental CDP hearing, the taxpayer submitted an offer-in-compromise offering to compromise all liabilities for $12,603. The IRS calculated the taxpayer's reasonable collection potential (RCP) as $1.5 million and issued a notice of determination rejecting the proposed offer-in-compromise. The taxpayer asserted that, in the first supplemental CDP hearing, the IRS had failed to address state law issues that could affect nominee and alter ego theories. In the second supplemental CDP hearing, the Appeals Officer increased the taxpayer's RCP to $19.5 million and issued a second supplemental notice of determination rejecting the taxpayer's offer-n-compromise and sustaining the proposed collection action. The Tax Court (Judge Kerrigan) held that the IRS Appeals Officer abused her discretion in upholding the proposed collection action and declined to sustain the notice of determination. Specifically, the court held that the Appeals Officer abused her discretion in determining the taxpayer's RCP in three respects. First, according to the Internal Revenue Manual, dissipated assets can be taken into account in determining a taxpayer's RCP if the transfer of assets took place within a three-year period immediately preceding the taxpayer's submission of an offer-in-compromise. (Generally, dissipated assets are those disposed of in an attempt to avoid payment of a tax liability, or disposed of after the tax is assessed for items other than the production of income or for the health and welfare of the taxpayer and family members.) Assets transferred outside the three-year look-back period can be taken into account if they were transferred within six months before or after the tax was assessed. The taxpayer had submitted the offer-in-compromise in March 2014. The tax had been assessed on April 19, 2010, which meant that the Appeals Officer could look back to assets transferred within six months of that date. The Appeals Officer, however, took into account $5 million that the taxpayer had contributed in 2004 to an irrevocable grantor trust established in the West Indies. The court found that, even after making this contribution, the taxpayer's net worth exceeded any potential tax liability and that the Appeals Officer had abused her discretion in treating trust assets as dissipated assets. The court also found that the Appeals Officer abused her discretion by treating as dissipated assets investments the taxpayer had made in residential and commercial real estate on the Gulf Coast region under Go Zone legislation from 2006 through 2010 that were lost due to issues such as Chinese drywall in some of the homes and the 2008 subprime mortgage crisis. "There is no indication in the record, and none was demonstrated at trial, that petitioner invested in the Go Zone in an attempt to avoid paying his 2001 tax liability." Second, the Appeals Officer determined that the West Indies trust was a nominee or alter ego of the taxpayer, and therefore the trust's assets could be taken into account in determining

RCP as amounts collectible from third parties. According to Drye v. United States, 528 U.S. 49 (1999), this conclusion requires an inquiry whether the taxpayer has rights in property under state law and, if so, whether the taxpayer's rights qualify as property rights under federal tax law. The taxpayer, as beneficiary of the trust and with limited rights to request distributions or to request replacement of the trustee, argued that he had no property interest in the trust's assets. The court found that the Appeals Officer had abused her discretion in determining that the trust was the taxpayer's nominee or alter ego because the IRS had produced no evidence that petitioner had a property right in the trust under state law. Third, the court held that the Appeals Officer had abused her discretion in determining that the taxpayer had control over the trust's assets and that the assets therefore could be taken into account in determining RCP as assets available to the taxpayer but beyond the reach of the government. The court found that the taxpayer did not have control over the trustee and specifically did not control the trustee's decision to invest in some of the Gulf Coast real estate projects of the taxpayer.

2. "The Freak" might no longer have a 40-inch vertical leap, but he managed to take down the IRS's notice of federal tax lien following a collection due process hearing on the basis that the Appeals Officer did not properly verify mailing of the notice of deficiency. Kearse v. Commissioner, T.C. Memo. 2019-53 (5/20/19). The taxpayer in this case, Jevon Kearse, who played for more than a decade in the NFL for the Tennessee Titans and the Philadelphia Eagles, took a business bad debt deduction of $1.36 million on his 2010 federal income tax return. The IRS disallowed the deduction and assessed tax in the amount of more than $400,000. In response to the IRS's notice of federal tax lien, the taxpayer requested a collection due process hearing. In the CDP hearing, the taxpayer submitted an offer in compromise based on doubt as to liability and offered to pay $1. He disputed the IRS's proper mailing and his receipt of the statutory notice of deficiency. The IRS Appeals Office issued a notice of determination sustaining the collection action, and the taxpayer sought review by filing a petition in the Tax Court. The Tax Court (Judge Ashford) held that it was an abuse of discretion for the IRS Appeals Officer to sustain the collection action. Sections 6320(c) and 6330(c) require the Appeals Officer conducting the CDP hearing to verify that the requirements of applicable law and administrative procedure have been met. The Appeals Officer was unable to secure United States Postal Service From 3877 to show proof of mailing of the notice of deficiency. She also did not request the statutory notice of deficiency. She instead examined the IRS's Integrated Data Retrieval System (IDRS) to verify that the notice of deficiency had been mailed. In the Tax Court, the IRS stipulated that the IRS was unable to produce USPS Form 3877. The court held that "the Appeals officer had failed to properly perform the verification mandated by section 6330(c), i.e., to properly verify that the assessment of petitioner's 2010 income tax liability was preceded by a duly mailed notice of deficiency." Specifically, the court stated:

> Where a taxpayer alleges that the notice of deficiency was not properly mailed to him, he has "alleged an irregularity" … thereby requiring the Appeals officers, according to further IRS guidance, to do more than "rely solely" on IDRS; they must review: (1) a copy of the notice of deficiency and (2) the USPS Form 3877 or equivalent IRS certified mail list bearing a USPS stamp or the initials of a postal employee. …[T]he Appeals officer here acknowledges that she did not secure (and accordingly review) either of these documents before the notice of determination was issued to petitioner.

The court also rejected the IRS's belated production of USPS Form 3877 because the IRS had stipulated that it could not produce this form.

3. The Tax Court declines jurisdiction in a case where the notice of federal tax lien was sent to the proper address and received by taxpayer. Atlantic Pacific Management Group, LLC v. Commissioner, 152 T.C. No. 17 (6/20/19). The petitioner, Atlantic Pacific Management Group, LLC (Atlantic) failed to file partnership information returns for two consecutive years. The IRS filed a notice of federal tax lien, sent a notice of federal tax lien filing to Atlantic, and assessed late filing penalties for both years. The notice of federal tax lien notified Atlantic of its right to request a collection due process (CDP) hearing. Though the notice was delivered and signed for, Atlantic did not timely request a CDP hearing and, although it submitted a late request for a CDP hearing, the IRS closed the case without conducting a CDP (or equivalent) hearing. The IRS also did not issue a notice of

determination. In general, under § 6320(a)(3)(B) and (b)(1), after receiving a notice of federal tax lien, a taxpayer has a thirty-day period within which to request a CDP hearing with the IRS Office of Appeals, following which IRS Appeals will issue a notice of determination. Once IRS Appeals issues the notice of determination, the taxpayer, pursuant to §§ 6320(c) and 6330(d)(1), can seek judicial review by filing a petition with the Tax Court. Notwithstanding that Atlantic had neither timely filed for a CDP hearing nor received a notice of determination, Atlantic filed a petition with the Tax Court asserting that the court should follow its holding in *Buffano v. Commissioner*, T.C. Memo 2007-32. In *Buffano*, the court held that, when jurisdiction is lacking, the court must nevertheless analyze the underlying facts to decide the proper basis for dismissal. Specifically, Atlantic argued that it had been deprived of its right to a CDP hearing and that the court should dismiss due to the IRS's failure to issue a valid notice of federal tax lien. The IRS, on the other hand, argued that the court should overrule its decision in *Buffano* and dismiss for lack of jurisdiction because the IRS had not issued a notice of determination. The court declined to adopt either of the parties' arguments, opting instead to "address some discrepancies in caselaw surrounding [the Court's] authority to determine whether requirements were complied with when determining jurisdiction." In doing so, the court distinguished *Buffano*. In *Buffano*, the taxpayer had failed to submit a timely request for a CDP hearing and had failed to show up for an equivalent hearing granted by the IRS. The court in *Buffano* dismissed and invalidated the underlying levy notice because it had not been mailed to the appropriate address. The court distinguished the lack of notice to the taxpayer in *Buffano* from Atlantic's actual receipt of proper notice. The court concluded that it lacked jurisdiction because no notice of determination had been issued. The court rejected Atlantic's final argument that § 7803(a)(3), the statutory taxpayer bill of rights (TBOR) enacted as part of the Protecting Americans from Tax Hikes Act of 2015, conferred jurisdiction on the court. According to Atlantic, § 7803(a)(3) gave "it a right to be heard and to appeal decisions of respondent to an independent forum." Unimpressed with this argument, the court held that § 7803(a)(3) provides no independent relief or additional rights to taxpayers and confers no power on the court to extend the deadline for requesting a CDP hearing beyond the thirty days prescribed by § 6320.

- The court's holding regarding the TBOR is consistent with *Moya v. Commissioner*, 152 T.C. No. 11 (4/17/19), in which the court held that the TBOR adopted by the IRS in 2014 did not add to a taxpayer's rights but merely "consolidat[ed] and articulat[ed] in 10 easily understood expressions rights enjoyed by taxpayers and found in the Internal Revenue Code and in other IRS guidance," and with *Facebook, Inc. v. Internal Revenue Service*, 121 A.F.T.R.2d 2018-1752 (N.D. Cal. 5/14/18), in which the court held that the statutory TBOR in § 7803(a)(3) did not grant taxpayers new, enforceable rights.

G. Innocent Spouse

1. Even a Johnny Cash song couldn't have told a story like this. A taxpayer prevails in her quest for innocent spouse relief. Contreras v. Commissioner, T.C. Memo. 2019-12 (2/26/19). The taxpayer sought innocent spouse relief under § 6015(f) with respect to the years 2006 through 2009. The taxpayer married her husband in August of 2000. He had his own home construction business and she stayed home to care for their two children and her husband's two children from a prior relationship. They lived in a mobile home on property in Liberty County, Texas (Lot 12) and planned to build a home on the lot next door, Lot 13. When they applied for financing to assist with construction, the taxpayer learned that Lot 13 was owned by her husband and the woman with whom he had previously been in a relationship. She and her husband were advised by an attorney that her husband was still in a common-law marriage with the other woman and that, to remove the other woman's name from the title to Lot 13, her husband would have to go through a divorce proceeding, which he did. This necessarily meant that, when the taxpayer had married her husband, he was already married and therefore the taxpayer had never been legally married to him. Ultimately, her husband built the house on Lot 13, largely using materials left over from various jobs of his home construction business, and the family moved into the home. During the course of their relationship, the taxpayer's husband was abusive and routinely came home in a drunken state. The police were called to their home on several occasions. When the taxpayer's husband came home in a drunken state, she and her husband

argued and on various occasions her husband kicked in a bedroom door, damaged property, threw the taxpayer's possessions outside the home, and committed other aggressive acts. On these occasions, the taxpayer often left the home with her children to go to the home of her grandmother. The taxpayer's husband had at least one affair with another woman during their marriage. Her husband handled the filing of their federal income tax returns. No returns were filed for the year 2006 through 2009. She was divorced from her husband in 2011. The decree of divorce awarded each spouse as separate property a one-half interest in Lots 12 and 13. In addition, the divorce decree awarded the taxpayer $127,050 and authorized the taxpayer to foreclose on her ex-husband's interest in Lots 12 and 13 if he did not pay this amount by a specified date. Her ex-husband failed to pay this amount and voluntarily transferred to the taxpayer his interests in Lots 12 and 13. The deed transferring title was prepared with the assistance of an attorney and recorded in the public land records. Just prior to their divorce, the IRS filed a notice of lien against her husband and, just after the divorce, the U.S. Department of Justice brought an action in the U.S. District Court seeking to reduce tax liabilities to judgment and to foreclose on the home on Lot 13 in which the taxpayer lived with her two children. Following their divorce, the taxpayer's ex-husband filed returns for 2008 and 2009 with the incorrect filing status of head-of-household. In 2013, in connection with an IRS audit of the years 2006 through 2009, the taxpayer signed joint returns for 2006 and 2007 as well as amended returns for 2008 and 2009 that were joint returns. She placed the words "as to form" next to her signature on the 2006 and 2007 returns. She repeatedly expressed that she did not understand the returns and did not understand why she had to sign a joint return with her ex-husband. She was represented in the course of the audit by an attorney whose fees were paid by her ex-husband. The IRS sought to hold the taxpayer liable for nearly $300,000 in taxes, penalties and interest for the years 2006 through 2009. The taxpayer filed an administrative request for innocent spouse relief, which the IRS denied. The taxpayer then filed a petition in the Tax Court. The Tax Court (Judge Paris) held that the taxpayer was entitled to innocent spouse relief under § 6515(f) (equitable relief) with respect to all of the years at issue. The taxpayer and the IRS agreed that the taxpayer met all threshold requirements for equitable relief under Rev. Proc. 2013-34, 2013-43 I.R.B. 397, except for one. The IRS asserted that assets (Lots 12 and 13) had been transferred between the spouses as part of a fraudulent scheme. The court rejected this argument largely on the basis that the transfer was made pursuant to rights granted to the taxpayer in the divorce decree and that the taxpayer and her husband had not attempted to conceal the transfer; they had recorded the transfer in the public land records. The court also rejected the IRS's arguments that the taxpayer was not entitled to streamlined relief under Rev. Proc. 2013-34. The IRS argued that the taxpayer would not suffer economic hardship if relief was not granted, which the court rejected on the basis that the taxpayer's only sources of income were child support payments, which were not reliable, and government assistance. The IRS also argued that streamlined relief was unavailable because the taxpayer had knowledge that her ex-husband would not or could not pay the liabilities in question. The court rejected this argument based on the taxpayer's credible testimony (as well as that of her daughter) regarding her ex-husband's abusive and controlling behavior.

- The taxpayer was represented by the Low Income Taxpayer Clinic at South Texas College of Law Houston.

H. Miscellaneous

1. No, you can't plead the Fifth Amendment to avoid a deficiency assessment under § 280E and, duh, when your company's name is "THC, LLC," the IRS probably is going to figure out that you sell marijuana. Feinberg v. Commissioner, 916 F.3d 1330 (10th Cir. 2/26/19). This case had some weird facts: an LLC aptly but perhaps stupidly named Total Health Concepts, LLC ("THC") that had elected subchapter S status. And it had some procedural quirks: the IRS agreed with the taxpayers (the members of THC, but treated as a subchapter S shareholders for federal income tax purposes) that the Tax Court's reasoning (failure to substantiate expenses) for upholding an asserted deficiency against the taxpayers should be overturned. Yet, the Tenth Circuit (Judge McHugh) nevertheless upheld the Tax Court's ultimate conclusion on the basis of § 280E. Section 280E disallows any deduction or credit otherwise allowable if such amount is paid or incurred in connection with a trade or business "if such trade or business (or the activities which comprise such trade or

business) consists of trafficking in controlled substances ….” The Tax Court had upheld the deficiency based upon the taxpayers’ failure to substantiate expenses; however, the Tenth Circuit ruled that this was improper because the notice of deficiency itself did not raise the issue of substantiation. The Tenth Circuit went on, however, to uphold the deficiency based upon the IRS’s alternative argument that § 280E disallowed the taxpayers’ deductions because the taxpayers had not met their burden of proof. Specifically, the IRS argued that the taxpayer failed to offer any evidence contrary to the notice of deficiency. The notice of deficiency asserted that the taxpayers’ LLC-S corporation, THC, was unlawfully trafficking in a controlled substance. An IRS notice of deficiency generally is presumed correct unless the taxpayer offers contrary evidence. Furthermore, the Tenth Circuit rejected the taxpayers’ argument that placing the burden of proof on them violated their Fifth Amendment privilege against self-incrimination. The Tenth Circuit held that, although the Fifth Amendment provides protection against self-incrimination in criminal proceedings, it does not shift the burden of proof to the IRS in a civil tax matter. As a result, because the deficiency was based upon the IRS’s disallowance of deductions under § 280E, and because the taxpayer had failed to provide any evidence that it was not in the marijuana business, the IRS’s position was upheld.

- *Although not mentioned by either court, the authors wonder,* “What was the taxpayer thinking? The company’s name was ‘THC, LLC.’ Didn’t the taxpayer consider that the company’s name might attract IRS attention?”

2. The D.C. Circuit has reversed a federal district court and held that the IRS can charge fees for issuing PTINs. Montrois v. United States, 916 F.3d 1056 (D.C. Cir. 3/1/19). A group of tax return preparers filed a class-action lawsuit in a U.S. District Court challenging the IRS’s practice of charging a fee for issuing preparer tax identification numbers (PTINs). The tax return preparers argued that the IRS lacked authority under the Independent Offices Appropriations Act to charge a fee for issuing and renewing PTINs and that the IRS’s decision to charge fees was arbitrary and capricious in violation of the Administrative Procedure Act. The U.S. District Court held that, although the IRS had statutory authority to require the use of PTINs by those who prepare tax returns for compensation, it lacked legal authority to charge fees for issuing PTINs. *Steele v. United States*, 119 A.F.T.R.2d 2017-2065 (D.D.C. 2017). The U.S. District Court declared all fees charged by the IRS for issuing PTINs unlawful, permanently enjoined the United States from charging such fees, and ordered the United States to refund all PTIN fees paid from September 1, 2010 to the present. *Steele v. United States*, 120 A.F.T.R. 2d 2017-5145 (D.D.C. 2017). The government appealed the U.S. District Court’s decision to the U.S. Court of Appeals for the District of Columbia Circuit. In an opinion by Judge Srinivasan, the D.C. Circuit reversed the District Court’s decision. As discussed in more detail below, the court held that the IRS acted within its authority under the Independent Offices Appropriations Act in charging tax return preparers a fee to obtain and renew PTINs and also concluded that the IRS’s decision to charge a fee was not arbitrary and capricious. The court remanded the case to the U.S. District Court for further proceedings, including a determination of whether the amount of the PTIN fee unreasonably exceeds the costs to the IRS to issue and maintain PTINs.

The Independent Offices Appropriations Act provides the IRS with legal authority to charge a fee for issuing PTINs. The D.C. Circuit reviewed its own prior decisions and those of the U.S. Supreme Court and, based on this review, reasoned that the Independent Offices Appropriations Act does not authorize federal agencies to tax, which is a legislative power, but rather to impose reasonable fees for benefits conferred on identifiable beneficiaries. According to the court, “[t]o justify a fee under the [Independent Offices Appropriations] Act, then, an agency must show (i) that it provides some kind of service in exchange for the fee, (ii) that the service yields a specific benefit, and (iii) that the benefit is conferred upon identifiable individuals.” The IRS, the court concluded, had met these requirements with respect to the fee charged for issuing a PTIN. The service provided by the IRS is the issuance of the PTIN, a unique identifying number for each tax-return preparer, and the maintenance of the database of PTINs, which enables preparers to use those numbers in place of their Social Security numbers on tax returns. This service yields a specific benefit, the court concluded, because it protects a tax-return preparer’s identity by allowing the preparer to list the PTIN on returns rather than the preparer’s social security number. The court also determined that this benefit is conferred upon identifiable individuals because tax-return preparers qualify as identifiable recipients for this purpose.

Although practically anyone can obtain a PTIN, the benefit of PTINs is conferred upon identifiable individuals (those who apply for them), just as the benefit of the State Department's fee for issuing a passport is conferred upon identifiable individuals (those who apply for passports).

The IRS's decision to charge a fee for issuing PTINs was not arbitrary and capricious. Under relevant provisions of the Administrative Procedure Act, 5 U.S.C. § 706(2)(A), an agency's decision must be the product of reasoned decision-making. The tax return preparers challenging the PTIN fees argued that this requirement was not met because the 2010 regulations that originally established the PTIN fee stated that the fee would pay for the registered tax-return preparer program, which was ruled invalid in *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014). The D.C. Circuit held, however, that the IRS had given adequate reasons for its decision to impose a fee independent of those rejected in *Loving*. Specifically, the court stated, "[w]hen the IRS reissued the PTIN fee regulations after *Loving*, it explained that PTINs would benefit preparers by protecting their confidential information and would improve tax compliance and administration."

- On May 24, 2019, the tax return preparers who challenged the IRS's ability to charge fees for issuing PTINs filed a petition for a writ of certiorari with the U.S. Supreme Court. The petition asks the Court to review the decision of the U.S. Court of Appeals for the District of Columbia Circuit. *Montrois v. United States*, Docket No. 18-1493 (U.S. 5/24/19).

3. Another lesson on mailing a petition to the Tax Court: the date printed on a postage label purchased through the internet will be disregarded if the envelope also bears a U.S. Postal Service postmark. Jordan v. Commissioner, T.C. Memo. 2019-15 (3/4/19). The last day for the taxpayer to file a Tax Court petition was March 6, 2018. The taxpayer, who represented herself, printed a label from Endicia.com, an online postage provider, dated March 6, 2018. The envelope containing the petition also bore two U.S. Postal Service postmarks dated March 7 and March 20, 2018. The Tax Court received and filed the petition on March 26, 2018 which was twenty days after the date shown on the Endicia.com label. The Tax Court (Judge Buch) dismissed the petition as having been untimely filed by relying on Reg. § 301.7502-1(c)(1)(iii)(B)(3), which provides:

> If the envelope has a postmark made by the U.S. Postal Service in addition to a postmark not so made, the postmark that was not made by the U.S. Postal Service is disregarded, and whether the envelope was mailed in accordance with this paragraph (c)(1)(iii)(B) will be determined solely by applying the rule of paragraph (c)(1)(iii)(A) of this section [regarding envelopes nearing U.S. postmarks].

The court noted that, in *Pearson v. Commissioner*, 149 T.C. 424 (11/29/17), a majority of the court had held that internet-purchased postage may qualify as a postmark not made by the U.S. Postal Service under § 7502(b). Because the envelope with the taxpayer's petition bore a private postmark of March 6, 2018, and later U.S. Postal Service postmarks, the court gave effect to the U.S. Postal Service postmarks. Because both of the U.S. Postal Service postmarks were dated after the last day of the 90-day period for filing a petition with the Tax Court, the court granted the government's motion to dismiss for lack of jurisdiction. The court further held that, even if it were to give effect to the March 6 date of the private postmark, it would still have to dismiss for lack of jurisdiction because, under Reg. § 301.7502-1(c)(1)(iii)(B)(1)(ii), in order to treat the date on a private postmark as the date of mailing for purposes of the timely-mailed-is-timely-filed rule, the item must have been received by the relevant agency not later than the time when a properly addressed and mailed envelope sent by the same class of mail would ordinarily be received if it were postmarked at the same point of origin by the U.S. Postal Service. In this case, the court noted, "[a]ccording to USPS delivery standards, an item sent by First Class mail from Detroit should arrive in Washington, D.C., in three days," but the taxpayer's petition had arrived twenty days after the date of the private postmark.

- For a case in which the envelope sent by the taxpayer bore only a private postmark and the taxpayer prevailed, see *Tilden v. Commissioner*, 846 F.3d 882 (7th Cir. 1/13/17), *rev'g* T.C. Memo 2015-188 (9/22/15).

4. When the IRS fails to review all evidence related to a whistleblower award, the Tax Court may grant the IRS's motion to remand the case back to the IRS to conserve the

court's resources. Whistleblower 769-16W v. Commissioner, 125 T.C. No. 10 (4/11/19). Pursuant to § 7623, the petitioner initially applied for seven separate whistleblower awards in relation to a tax-avoidance scheme allegedly perpetrated by various taxpayers. In late 2011, after referring the petitioner's claims to the IRS's Large Business and International (LB&I) Division, LB&I concluded that when the claims for award were submitted, the IRS was aware of the tax-avoidance scheme and each of the reported taxpayers was already under examination. Over the course of the same general time period, the petitioner provided a congressional committee responsible for investigations with similar information regarding the tax-avoidance scheme in relation to the same taxpayers. The petitioner later applied for additional whistleblower awards in relation to additional taxpayers. In 2014 (date unclear), the congressional committee issued its report regarding the tax-avoidance scheme to the IRS. Thereafter, the IRS Whistleblower Office issued a final determination summarily denying all of petitioner's claims indicating the information provided by petitioner did not result in any action or change in position taken by the IRS. On appeal to the Tax Court, the petitioner objected to, among other things, the IRS's motion to remand the case back to the IRS because, as conceded by the IRS, the Whistleblower Office had not considered whether the IRS might have proceeded on the basis of information the petitioner brought to the IRS's attention as part of the congressional committee report. In a unanimous, reviewed opinion by Judge Thornton in a case of first impression, the Tax Court granted the IRS's motion to remand the case to the IRS. Remanidn to the IRS is appropriate, the court held, where the IRS identifies substantial concerns related to its ruling and where the remand will conserve the court's resources. The court cautioned that remand will be granted only if the petitioner will not be unduly prejudiced. In coming to these conclusions, the court relied on its recent decision in *Kasper v. Commissioner*, 150 T.C. No. 2 (1/9/18), in which the court held that its standard of review in a whistleblower case is for abuse of discretion. The court in *Kasper* also noted that it examines requests for innocent spouse relief under § 6015 under a de novo standard of review. In contrast, the court's standard of review is for abuse of discretion in both collection due process (CDP) cases and whistleblower cases. Thus, while the court may remand a CDP case for abuse of discretion, cases arising under § 6015 are reviewed de novo and are not subject to remand. Cases in the latter category are reviewed de novo because they "are not a 'review' of the Commissioner's determination in a hearing but are instead an action begun in this Court." *Friday v. Commissioner*, 124 T.C. at 222 (fn. ref. omitted). Again citing its decision in *Kasper*, the court further held that, in reviewing whistleblower award determinations for abuse of discretion, the court will not substitute its judgement for that of the Whistleblower Office. Instead, the court decides "whether the agency's decision was 'based on an erroneous view of the law or a clearly erroneous assessment of the facts.'" The court then adopted the standard set forth by the U.S. Supreme Court in *Camp v. Pitts*, 411 U.S. 138 (1973), for remanding a case to an administrative agency as follows:

> If the record before the agency does not support the agency action, if the agency has not considered all relevant factors, or if the reviewing court simply cannot evaluate the challenged agency on the basis of the record before it, the proper course, except in rare circumstances, is to remand to the agency for additional investigation or explanation.

411 U.S. at 142. Thus, under *Camp*, the Tax Court may now remand cases to the Whistleblower Office for further consideration. Because any appeal of this case will be considered by the U.S. Court of Appeals for the District of Columbia Circuit, the Court turned to *Util. Solid Waste Activities Grp. v. EPA*, 901 F.3d 414 (D.C. Cir. 2018), to explain the manner in which discretion should be used in granting motions to remand:

> We generally grant an agency's motion to remand so long as "the agency intends to take further action with respect to agency decision on review." Remand has the benefit of allowing "agencies to cure their own mistakes rather than wasting the courts' and the parties' resources reviewing a record that both sides acknowledge to be incorrect or incomplete." Remand may also be appropriate if the agency's motion is made in response to "intervening events outside the agency's control, for example, a new legal decision or passage of new legislation." Alternatively, "even if there are no intervening events, the agency may request a remand (without confessing error) in order to

> reconsider its previous position." *Util. Solid Waste Activities Grp. v. EPA*, 901 F.3d 414, 436 (D.C. Cir. 2018).

These considerations, the court reasoned, supported granting the IRS's motion to remand.

5. Even if the IRS violated certain rights enumerated in the Taxpayer Bill of Rights adopted by the IRS, the violations do not provide a basis for invalidating a notice of deficiency issued to the taxpayer. Moya v. Commissioner, 152 T.C. No. 11 (4/17/19). The IRS disallowed deductions the taxpayer had claimed with respect to a business activity on Schedule C of her 2011, 2012, and 2013 federal income tax returns. During those years she was a professor at the College of Southern Nevada. She subsequently moved to Santa Cruz, California. The IRS examination of the taxpayer's returns was conducted by the IRS office in Las Vegas, Nevada. Through written correspondence, the taxpayer requested that the examination of her returns be transferred to an IRS office near her home in Santa Cruz and that a hearing scheduled in Las Vegas take place instead in Santa Cruz. The IRS subsequently issued a notice of deficiency in which it disallowed the taxpayer's deductions on Schedule C. The taxpayer filed a petition in the Tax Court. In the petition, the taxpayer gave the following reasons for challenging the proposed disallowance:

> Although she requested that the examination of her returns be set near her home, in Santa Cruz, it was set in Las Vegas; her phone calls to the IRS went unreturned; she received contradictory information as to where the examination of her returns would take place; and she received inconsistent requests for information.

The taxpayer asserted that the Taxpayer Bill of Rights (TBOR) adopted by the IRS in 2014 (see IR-2014-72 (6/10/14)) gave her the right to have her questions answered and the right to meet with an IRS representative at a time and place convenient to her, and that she had been accorded neither right. The taxpayer's position was that, in examining her returns, the IRS had violated her rights to be informed, to challenge the IRS position and be heard, and to a fair and just tax system. The IRS argued that, pursuant to the principle set forth in *Greenberg's Express, Inc. v. Commissioner*, 62 T.C. 324 (1974), a proceeding in the Tax Court to redetermine a deficiency is a proceeding de novo, and therefore the Tax Court generally is precluded from looking behind a notice of deficiency to examine the IRS's policy or procedures in making determinations. The Tax Court (Judge Halpern) ruled in favor of the IRS for two reasons. *First*, the court explained, the TBOR adopted by the IRS did not add to her rights. The court traced the history of the TBOR and concluded that it merely "consolidat[ed] and articulat[ed] in 10 easily understood expressions rights enjoyed by taxpayers and found in the Internal Revenue Code and in other IRS guidance." *Second*, the court reasoned, even if the taxpayer's claims were true, they did not provide a basis for invalidating the notice of deficiency because the taxpayer had a full opportunity to challenge the IRS's proposed adjustments in the Tax Court. Instead of taking advantage of this opportunity, the court stated, the taxpayer had instead challenged the IRS's right to make those determinations on the basis that it had violated unspecific statutory rights.

- In the Protecting Americas from Tax Hikes (PATH) Act of 2015, Congress amended § 7803(a)(3), which provides that, "[i]n discharging his duties, the Commissioner shall ensure that employees of the Internal Revenue Service are familiar with and act in accord with taxpayer rights as afforded by other provisions of this title, including" ten specific rights. These include "the right to be informed" and "the right to a fair and just tax system." In *Facebook, Inc. v. Internal Revenue Service*, 121 A.F.T.R.2d 2018-1752 (N.D. Cal. 5/14/18), the court held that the statutory TBOR in § 7803(a)(3) did not grant taxpayers new, enforceable rights. In *Atlantic Pacific Management Group, LLC v. Commissioner*, 152 T.C. No. 17 (6/20/19), the Tax Court held that § 7803(a)(3) provides no independent relief or additional rights to taxpayers and confers no power on the court to extend the deadline for requesting a collection due process hearing beyond the thirty days prescribed by § 6320.

6. A federal district court concluded that Form 1099-A issued by a mortgage lender showed only that the lender had acquired the property serving as security for the loan, not that the loan had been canceled, which would have been reported on form 1099-C, and therefore dismissed borrower's claim that the lender caused him to owe more tax than he properly owed. Helmert v. Cenlar FSB, 123 A.F.T.R.2d 2019-2287 (D. Miss. 6/18/19). John Helmert,

Jr., and his former wife financed the purchase of their home and executed a deed of trust in favor of the lender. They later refinanced their home loan with a different lender and executed a deed of trust in favor of the new lender. The new deed of trust ultimately was assigned to a lender that conducted a foreclosure sale. Mr. Helmert brought this legal action in which he asserted various claims against the lenders involved, including a claim for wrongful foreclosure. One of the claims he asserted was that the lender that foreclosed improperly issued two Forms 1099-A that caused his tax liability to be greater than the amount he actually owed. The lenders against whom the action was brought moved to dismiss his claims. The District Court (Judge Mills) dismissed some of Mr. Helmert's claims, including his claim that the lender's improper issuance of the Forms 1099-A had increased his tax liability. Mr. Helmert asserted that Form 1099-A is issued to reflect loan forgiveness. The court explained that Form 1099-C, not Form 1099-A, is issued to reflect cancellation of debt. Form 1099-A, the court stated, "merely shows that the lender has acquired the property serving as security for its loan, while also stating the balance owed and the fair market value of the property." Because Mr. Helmert had not submitted Form 1099-C or his individual income tax return to support his claim that the lender had caused him to have an increased tax liability, the court dismissed his claim.

- The instructions to Form 1099-A discuss the coordination of Forms 1099-A and 1099-C. The instructions state: "If, in the same calendar year, you cancel a debt of $600 or more in connection with a foreclosure or abandonment of secured property, it is not necessary to file both Form 1099-A and Form 1099-C, Cancellation of Debt, for the same debtor. You may file Form 1099-C only. You will meet your Form 1099-A filing requirement for the debtor by completing boxes 4, 5, and 7 on Form 1099-C. However, if you file both Forms 1099-A and 1099-C, do not complete boxes 4, 5, and 7 on Form 1099-C."

7. IRS expands voluntary IP PIN program to a total of nine states and the District of Columbia. An Identity Protection Personal Identification Number (IP PIN) is a six-digit number assigned to eligible individuals that must be used on a tax return, in addition to the individual's Social Security number (SSN), to verify the individual's identity. The IP PIN helps prevent a taxpayer's SSN from being used on a fraudulent federal income tax return. The IRS assigns an IP PIN to taxpayers who are victims of identity theft or those who are suspected of being victims of identity theft. For the 2016 filing season, the IRS implemented a pilot program under which taxpayers who filed returns during the prior year from the District of Columbia, Florida and Georgia are eligible to obtain an IP PIN on a voluntary basis even though they have not experienced identity theft. FL-2016-03 (1/26/16). For the 2019 filing season, the IRS expanded this program to include California, Delaware, Illinois, Maryland, Michigan, Nevada, and Rhode Island. The IRS selected these nine states and the District of Columbia because they have higher levels of identity theft. Taxpayers who filed returns from these jurisdictions in the prior year can obtain an IP PIN by using the IRS's online Get An IP PIN tool. To obtain an IP PIN, taxpayers will need to complete successfully the IRS's identity verification secure access process. If its systems can handle the expansion, the IRS plans eventually to offer the voluntary IP PIN program to taxpayers in all states, a move that is supported by the AICPA.

8. IRS releases final regulations permitting use of truncated taxpayer-identification numbers on Forms W-2 furnished to employees. T.D. 9861, Use of Truncated Taxpayer Identification Numbers on Forms W–2, Wage and Tax Statement, Furnished to Employees, 84 F.R. 31717 (7/3/19). These final regulations adopt, without substantive change, proposed regulations issued in 2017 under § 6051, § 6052, and § 6109 (REG 105004-16, Use of Truncated Taxpayer Identification Numbers on Forms W-2, Wage and Tax Statement, Furnished to Employees, 82 F.R. 43920 (9/20/17)) that permit employers voluntarily to truncate employees' social security numbers (SSNs) on copies of Forms W–2 that are furnished to employees (including Forms W-2 reporting payment of wages in the form of group-term life insurance) so that the truncated SSNs appear in the form of IRS truncated taxpayer-identification numbers (TTINs). Employers are not permitted to truncate SSNs on Forms W-2 filed with the IRS or with the Social Security Administration. Similarly, TTINs may not be used on statements furnished to employers of a payee who received sick pay (such as a statement furnished to the employer of an employee by an insurance company making payments to an employee who is temporarily absent from work due to sickness or disability). According to Reg.

§ 301.6109-4(a), a TTIN "is an individual's social security number (SSN), IRS individual taxpayer identification number (ITIN), IRS adoption taxpayer identification number (ATIN), or IRS employer identification number (EIN) in which the first five digits of the nine-digit number are replaced with Xs or asterisks. The TTIN takes the same format of the identifying number it replaces, for example XXX-XX-1234 when replacing an SSN, or XX-XXX1234 when replacing an EIN." The final regulations apply to returns, statements, and other documents required to be filed or furnished after December 31, 2020, except for the rules regarding information returns filed with the Social Security Administration, which apply as of July 3, 2019.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. Caught between a rock and a hard place: "the boss told me to do it" defense doesn't work to avoid liability for trust fund taxes, even when "the boss" is another federal government agency! Myers v. United States, 923 F.3d 1050 (11th Cir. 7/24/19). The taxpayer in this case was the CFO and co-President of two companies that failed to pay over to the IRS withheld employment taxes. At the time the two companies failed to pay over employment taxes, they were owned by a limited partnership parent company (a Small Business Investment Company or "SBIC") that was held under receivership by the Small Business Administration ("SBA"). The taxpayer maintained that he should not be held liable under § 6672(a) for the companies' failure to pay over employment taxes because an agent of the SBA told him to "prioritize other vendors over the trust fund taxes," which he did. After the taxpayer was assessed trust fund tax penalties by the IRS under § 6672(a), the taxpayer paid a portion of the assessment and sued for a refund in U.S. District Court for the Northern District of Georgia. The District Court granted summary judgment in favor of the government. On appeal to the Eleventh Circuit, the taxpayer argued that, although the "boss told me to do it" defense has been rejected in a number of decided cases involving private companies, the taxpayer's situation should be treated differently. Here, the taxpayer contended, the "boss" was another federal government agency. Therefore, according to the taxpayer, he was caught between a rock and hard place: either ignore the SBA or ignore the IRS, both of which are federal government agencies. Nevertheless, the Eleventh Circuit, in a per curiam opinion by Judges Tjoflat, Jordan, and Schlesinger (the latter a District Judge sitting by designation) affirmed the District Court and held against the taxpayer, stating that § 6672(a) applies with "equal force when a government agency receiver tells a taxpayer not to pay trust fund taxes."

In a concurring opinion, Judge Jordan agreed with the result, but stated that the decision should be based on narrower grounds. As justification for his concern over the breadth of the court's holding, Judge Jordan cited *McCarty v. United States*, 437 F.2d 961 (Ct. Cl. 1971), where a taxpayer avoided responsible person liability under the predecessor of § 6672(a) in circumstances where the U.S. Navy had taken control of a company. Judge Jordan explained that in his view the taxpayer's real argument was that the IRS should be estopped from collecting trust fund taxes under § 6672(a) because the taxpayer was acting at the direction of another federal government agency. Judge Jordan further explained, though, that an estoppel argument by the taxpayer must be based upon the premise that the taxpayer's decision was objectively reasonable under the facts. Here, Judge Jordan wrote, a federal statute, 28 U.S.C. § 960, provides that "[a]ny officers and agents conducting any business under authority of a United States court shall be subject to all Federal . . . taxes applicable to such business to the same extent as if it were conducted by an individual or corporation." Given this express statutory directive, Judge Jordan concluded that the taxpayer could not have reasonably relied upon the "do-not-pay instructions" of the SBA receiver and the IRS thus should not be estopped from collecting trust fund taxes from the taxpayer under § 6672(a).

B. Self-employment Taxes

1. IRS announces that payroll tax compliance is a top priority. IR-2019-71 (4/11/19). The IRS is making payroll tax compliance a top priority. As part of its efforts in this area, in March and April 2019, the IRS conducted a national two-week education and enforcement campaign

to combat employment tax crimes. During these two weeks, the IRS visited nearly 100 businesses showing signs of potential serious noncompliance and the IRS Criminal Investigation (CI) Division indicted 12 individuals, executed four search warrants and saw six individuals or businesses sentenced for crimes associated with payroll taxes. The IRS announcement indicated that payroll taxes withheld by employers account for nearly 72 percent of all revenue collected by the IRS. Because of the importance of payroll taxes to the tax system, said IRS Commissioner Chuck Rettig, "[t]he IRS is committed to compliance in the payroll tax arena, which helps ensure fairness and faith in our tax system." According to Don Fort, Chief of IRS Criminal Investigation, "[e]mployers know the rules—they must deposit and report employment taxes accurately—this is non-negotiable." To bolster payroll tax compliance, the IRS has several tools, including "educational outreach, data analytics, civil investigations by highly trained revenue officers, as well as harsher measures such as lawsuits, seizures and criminal referrals to IRS CI." Resources on complying with and managing payroll tax obligations are available on the IRS website.

2. An author's trade or business included both writing and developing her brand and therefore all income she received under publishing contracts, including any portion paid for her name and likeness, was subject to self-employment tax. Slaughter v. Commissioner, T.C. Memo. 2019-65 (6/4/19). Karin Slaughter, an author of crime fiction, worked since the 1990s to establish herself as a "brand author," one who provides prestige or reliable profits to a publishing house. She worked with an agent to obtain a contract with a New York publishing house and with a media coach and publishers to develop her name and likeness into a successful brand. During the years in question, 2010 and 2011, she spent 12 to 15 weeks writing in Georgia, her state of residence, and also "spent time meeting with publishers, agents, media contacts, and others to protect and further her status as a brand author." During 2010 and 2011, she received two types of payments under contracts she had entered into during the years 1999 through 2011: nonrefundable advance payments and royalties based on the sales generated by her manuscripts. The contracts gave the publishers not only the right to print, publish, distribute, sell, and license the works and manuscripts written by the taxpayer, but also the right to use her name and likeness in advertising, promotion, and publicity for the contracted works and the right to advertise other works in her books. The publishing contracts also required the taxpayer to provide photographs and appear at promotional events and contained various forms of noncompete clauses. The publishing contracts did not allocate the taxpayer's compensation in any way, i.e., did not specify a portion allocable to acquiring the right to print, publish, and license her works and did not specify a portion allocable to acquiring the right to use her name and likeness.

On her 2010 and 2011 federal income tax returns, the taxpayer deducted as business expenses the cost of leasing a vehicle to attend media interviews and promotional events, the cost of hosting her own promotional events, and the rent she paid on an apartment in New York City, which she maintained to facilitate her professional activities there. The taxpayer's federal income tax returns for 2010 and 2011 were prepared by a CPA who concluded that the taxpayer's earned income was the compensation she received for actually writing but that any income she received under the contracts beyond compensation for writing was paid for use of her name and likeness, which was "payment for an intangible asset beyond that of her trade or business as an author" and therefore not subject to self-employment tax. On the taxpayer's 2010 and 2011 returns, the advances and royalties she received were reported on Schedule E, Supplemental Income and Loss, and the portion relating to her trade or business of writing was subtracted and reported on Schedule C, Profit or Loss from Business. The CPA who prepared Ms. Slaughter's returns allocated her advance payments and royalties to Schedule C based on the portion of the year that she told the CPA was the amount of time she spent writing, which was 12 to 15 weeks. The 2010 and 2011 returns took the position that only the portion of the advance payments and royalties allocated to Schedule C was subject to self-employment tax. The IRS argued that all of Ms. Slaughter's income was directly or indirectly tied to the selling of her books and therefore was subject to self-employment tax.

The Tax Court (Judge Wells) held that the taxpayer's brand was part of her trade or business and that her income under the publishing contracts therefore was subject to self-employment tax. The court reasoned that she had devoted significant efforts over many years to develop her brand. These efforts included meeting with publishers, agents, media contacts, and others to protect and further her

status as a brand author, attending interviews and promotional events, and using social media, websites, and a newsletter to maintain her brand with her readership. The court concluded that "[s]uch sales-focused work is sufficiently routine that we consider it part of petitioner's trade or business." The court also reasoned that the taxpayer's treatment of her expenses on the returns supported treating payments received for her brand as part of her trade or business. She had deducted as business expenses the cost of leasing a vehicle to attend media interviews and promotional events, the cost of hosting her own promotional events, and the rent she paid on an apartment in New York City. The court concluded that, if brand-related expenditures are deductible on Schedule C, then the income derived from the brand is also income derived from a trade or business. The court declined to impose accuracy-related penalties for negligence or disregard of rules or regulations because she reasonably relied in good faith on a professional adviser. The court reasoned that she had satisfied the three factors required to establish a reasonable cause defense: (1) the adviser was a competent professional with sufficient expertise to justify reliance because the adviser was a CPA with many decades of experience; (2) the taxpayer had provided necessary and accurate information to the preparer; and (3) the taxpayer, who had no background in finance, law, or tax, actually relied in good faith on the preparer's judgment.

3. Partners are self-employed, even if they are employees of a disregarded entity owned by the partnership. T.D. 9869, Self-Employment Tax Treatment of Partners in a Partnership That Owns a Disregarded Entity, 84 F.R. 3178 (7/2/19). Treasury and the IRS have finalized, with only minor changes, proposed and temporary amendments to the check-the-box regulations under § 7701 (T.D. 9766, Self-Employment Tax Treatment of Partners in a Partnership That Owns a Disregarded Entity, 81 F.R. 26693 (5/4/16).) The amendments clarify that a partner in a partnership is considered self-employed even if the partner is an employee of a disregarded entity owned by the partnership. Prior to amendment, the check-the-box regulations provided that (1) a single-member business entity that is not classified as a corporation under Reg. § 301.7701-2(b) is disregarded as an entity separate from its owner; (2) such a disregarded entity nevertheless is treated as a corporation for employment tax purposes, which means that the disregarded entity, rather than its owner, is considered to be the employer of the entity's employees for employment taxes purposes; and (3) the rule that the disregarded entity is treated as a corporation for employment tax purposes does not apply for self-employment tax purposes. The regulations state that the owner of a disregarded entity that is treated as a sole proprietorship is subject to tax on self-employment income and provide an example in which the disregarded entity is subject to employment tax with respect to employees of the disregarded entity, but the individual owner is subject to self-employment tax on the net earnings from self-employment resulting from the disregarded entity's activities. Reg. § 301.7701-2(c)(2)(iv)(C)(2), -2(c)(2)(iv)(D), Ex. The IRS's longstanding position has been that a partner is self-employed and that any remuneration the partner receives for services rendered to the partnership are not wages subject to FICA, FUTA, and income tax withholding. Rev. Rul. 69-184, 1969-1 C.B. 256. Nevertheless, some taxpayers apparently have taken the position that, because the regulations do not include an example illustrating how the rules apply to a disregarded entity owned by a partnership, an individual partner in a partnership that owns a disregarded entity can be treated as an employee of the disregarded entity and therefore can participate in certain tax-favored employee benefit plans. The final amendments clarify that a disregarded entity is not treated as a corporation for purposes of employing either its individual owner, who is treated as a sole proprietor, or employing an individual that is a partner in a partnership that owns the disregarded entity. Instead, the entity is disregarded as an entity separate from its owner for this purpose and is not the employer of any partner of a partnership that owns the disregarded entity. A partner in a partnership that owns the disregarded entity is subject to the normal self-employment tax rules.

- The IRS's position that a partner cannot be an employee of a disregarded entity owned by the partnership means that compensation to the partner for services rendered to the disregarded entity cannot be reported on Form W-2 and instead must be reported on a Schedule K-1 issued by the partnership. This position also means that such a partner cannot participate in tax-favored employee benefit plans such as cafeteria plans and flexible spending accounts.

- The final regulations apply on the later of (1) August 1, 2016, or (2) the first day of the latest-starting plan year beginning after May 4, 2016, and on or before May 4, 2017, of an

affected plan sponsored by a disregarded entity. An affected plan includes any qualified plan, health plan, or §125 cafeteria plan if the plan benefits participants whose employment status is affected by these regulations.

- The final regulations do not address the application of Rev. Rul. 69-184, 1969-1 C.B. 256 (setting forth the IRS's position that a partner is not an employee of the partnership) to either tiered partnerships or publicly traded partnerships. The preamble to the final regulations indicates that the IRS will continue to consider these issues.

C. Excise Taxes

XII. TAX LEGISLATION

A. Enacted

1. Congress has enacted the Taxpayer First Act. The Taxpayer First Act, Pub. L. No. 116-25, was signed by the President on July 1, 2019. This legislation codifies and renames the IRS appeals function as the IRS Independent Office of Appeals, requires the IRS to develop a comprehensive customer service strategy, requires the Treasury Department to develop a comprehensive written plan to reorganize the IRS, and makes several significant changes to procedural tax rules.

2. The Further Consolidated Appropriations Act produces a hodgepodge of tax provisions. The Further Consolidated Appropriations Act, 2020, Pub. L. No. 116-94, was signed by the President on December 20, 2019. This legislation repealed the taxes commonly known as the medical device tax and the Cadillac tax, modified the rules for contributions to and distributions from certain retirement plans, temporarily extended several expired or expiring provisions, and provided tax relief to those in areas affected by certain natural disasters.

DISCLOSURE ISSUES FOR TAX-EXEMPT ORGANIZATIONS

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I. INTRODUCTION

Tax-exempt organizations are not immune from crises and reputational attacks. In extreme cases, a crisis might arise from serious mismanagement, egregiously improper conduct, and even systemized criminal activity. In these cases, public inquiry and media scrutiny can have the salubrious effect of bringing about fundamental change or causing a true bad-actor to close its doors, preventing future harm.

More frequently, an otherwise well-run organization may experience an unfortunate accident, lapse in judgement or protocol, or financial challenges that affect important programs. It is critical that stakeholders and the general public have appropriate information about these events. At the same time, the public interest is not served if a single unfortunate event destroys a good organization or prevents an organization from righting itself and continuing its good works.

Like all organizations, exempt organizations should consider doing contingency planning, to think through the things that could affect the organization if a crisis were to occur.[1] As part of the planning, organization leaders should "practice" for a crisis, perhaps through a table-top exercise in which participants mimic a crisis, and talk through the various constituents who would need to be involved in responding to it.[2] While the crisis an organization role-plays often is not the one that actually arises in the real world, by doing the exercise, organization leaders will develop muscle memory for responding to crises and will be better able to "kick into gear" when any crisis arises.[3]

Exempt organizations also should consider implementing a crisis communication plan, which provides a roadmap for information flow and decision-making when a serious and acute crisis occurs.

Not every unfortunate event justifies the use of a crisis communication plan, however. A challenging situation might require special attention without rising to the level of "crisis." Or, a reputational attack may develop slowly, giving the organization enough time to respond to and diffuse the situation before it rises to the level of "crisis." In these less-urgent situations, the full crisis communication plan would be out of proportion to the threat. In these situations, organization leaders use their own judgement to balance the competing concerns of candor, privacy, reputation, and disclosure.

As a general rule, it rarely is a good idea to unnecessarily withhold information that is going to "come out" eventually. BNYMellon President and Johns Hopkins University Carey Business School Financial Business Advisory Board member, Karen Peetz states that "transparency equals trust" and is one of the most critical elements beneath the surface in any crisis.[4] Further, tax-exempt nonprofit organizations are subject to a variety of public disclosure rules pursuant to which they have to make certain information available to the public. At the same time, an organization reasonably might want to manage the flow of information, whether to limit disclosure of damaging facts, slow the pace of a frenetic attack, or protect itself from a harassment campaign. By understanding the applicable rules, an organization can meet its legal obligations while avoiding undue (or overly swift) disclosure.

The following sections describe the disclosure regimes that nonprofit corporations that are described in I.R.C. §501(c) and exempt from tax under I.R.C. §501(a) are subject. This information is designed to help organization leaders balance the need for disclosure and privacy as they navigate challenging situations.

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[1] *See generally,* Karen Peetz "The Tylenol Strategy," Carey Business (Spring 2016) p.13, *available at* www.carey.jhu.edu/careybusiness.
[2] *Id.*
[3] *Id.*
[4] *Id.*

II. FEDERAL DISCLOSURE REQUIREMENTS

A. In General

Section 6014 of the Internal Revenue Code requires that certain information (namely, tax exempt status materials and annual information returns) required from tax-exempt organizations be made public.[5] Any person who is required to comply with the public disclosure requirements and who willfully fails to do so is subject to a penalty of $5,000 with respect to each document that is not properly disclosed.[6]

The information must be made available for inspection during regular business hours at the principal office of the organization.[7] If, the organization regularly maintains one or more regional or district offices having three or more employees, the materials must be made available at each regional or district office.[8] A "regional or district office" is any office of the organization, other than its principal office, that has paid employees, whether full-time or part-time, whose aggregate number of paid hours a week are normally at least 120.[9] A site is not considered a regional or district office if:

- The only services provided at the site further exempt purposes (such as day care, health care, or scientific or medical research); and
- The site does not serve as an office for management staff, other than managers who are involved solely in managing the exempt function activities at the site.[10]

The organization must provide a copy of its information to any individual upon request.[11] The copy must be furnished at no charge, except that the organization may charge a reasonably fee for any copying or mailing charges.[12]

B. Exempt Status Application Materials

An organization must make its exempt status application materials available for public inspection.[13]

For purposes of the disclosure rules, the term "exempt status application materials" includes:

- The prescribed application form (Form 1023, Form 1023-EZ, or Form 1024);
- All documents and statements the Internal Revenue Service requires applicants to file with the Form;
- Any statement or other supporting document submitted by the organization in support of its application (such as a legal brief or a response to questions from the Internal Revenue Service during the application process); and
- Any letter or other document issued by the Internal Revenue Service concerning the application (such as a favorable determination letter or a list of questions about the application).[14]

Under the regulations, the term "application for tax exemption" does <u>not</u> include:

- Any application for tax exemption filed by an organization that has not yet been recognized, on the basis of the application, by the Internal Revenue Service as exempt from taxation for any tax year;

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[5] Special rules apply regarding documents that must be provided by local and subordinate organizations covered by a group exemption letter. *See* Treas. Reg. §301.6104(d)-1(f).
[6] I.R.C. §6685.
[7] I.R.C. §6104(d)(1)(A).
[8] *Id.*
[9] Treas. Reg. §301.6104(d)-1(b)(5).
[10] *Id.*
[11] I.R.C. §6104(d)(1)(B).
[12] *Id.*
[13] I.R.C. §6104(d)(1)(A)(iii).
[14] Treas. Reg. §301.6104(d)-1(b)(3)(i).

- Any application for tax exemption filed before July 15, 1987, unless the organization filing the application had a copy of the application on July 15, 1987;
- In the case of a tax-exempt organization other than a private foundation, the name and address of any contributor to the organization; and
- Any material that is not available for public inspection under I.R.C. §6014.[15]

Form 8976, "Notice of Intent to Operate Under Section 501(c)(4)"[16] is not subject to public inspection because it is not an "application" within the meaning of I.R.C. §6104.[17]

C. Annual Information Returns

An organization must make its annual information return (Form 990, Form 990-PF, Form 990-EZ) available for public inspection.[18] An I.R.C. §501(c)(3) organization also must make available for public inspection and copying any Form 990-T, *Exempt Organization Business Income Tax Return*, filed after August 17, 2006.[19] The requirement extends to any amended return the organization files with the Internal Revenue Service after the date the return is filed.[20] Each annual return must be made available for a period of three years beginning on the date the return is required to be filed (including extensions) or is actually filed, whichever is later.[21] Stated differently, an organization does not need to provide access to or copies of returns that are more than three years old.

Although a regional or district office ordinarily must satisfy the same rules as the principal office with respect to allowing public inspection and providing copies of documents, it is not required to make its annual information return available for inspection or to provide copies until 30 days after the date the return is required to be filed (including extensions) or is actually filed, whichever is later.[22]

The return made available for inspection or provided as a copy must be an exact copy of the return that was filed.[23] It must include all information furnished to the Internal Revenue Service on the return, as well as all schedules, attachments, and supporting documents.[24] For example, in the case of a Form 990, the copy must include Schedule A to Form 990 and those parts of the return that show compensation paid to specific persons.[25]

In the case of a tax-exempt organization other than a private foundation, the name and address of any contributor to the organization does <u>not</u> need to be included.[26]

D. Rules for Public Inspection

1. <u>Monitoring the Inspector</u>

An organization may have an employee present in the room during an inspection of its exemption application materials or annual information returns.[27] The organization must allow the individual conducting the inspection to

[15] Treas. Reg. §301.6104(d)-1(b)(3)(iii).
[16] Electronic form required by new I.R.C. §506, added by the Protecting Americans from Tax Hikes Act ("PATH Act") in December 2015.
[17] T.D. 9775, Preamble §5.
[18] I.R.C. §6104(d)(1)(A)(i).
[19] I.R.C. §6104(d)(1)(A)(ii).
[20] Treas. Reg. §301.6104(d)-1(b)(4)(i).
[21] Treas. Reg. §301.6104(d)-1(a).
[22] Treas. Reg. §301.6104(d)-1(e).
[23] Treas. Reg. §301.6104(d)-1(b)(4)(i).
[24] *Id.*
[25] *Id.*
[26] Treas. Reg. §301.6104(d)-1(b)(4)(ii).
[27] Treas. Reg. §301.6104(d)-1(c)(1).

take notes freely during the inspection.[28] If the individual provides photocopying equipment at the place of inspection, the organization must allow the individual to photocopy the document at no charge.[29]

2. Organizations Without Offices

If an organization does not maintain a permanent office, it must comply with the public inspection requirements by making its application for exemption and annual information returns available for inspection at a reasonable location of its choice.[30] The organization must permit public inspection within a reasonable amount of time after receiving a request for inspection (normally not more than two weeks) and at a reasonable time of day.[31] At the organization's option, it may mail, within two weeks of receiving the request, a copy of its application for tax-exemption and annual information returns to the requester in lieu of allowing an inspection.[32] The organization may charge the requester for copying and actual postage costs only if the requester consents to the charge.

An organization that has a permanent office, but has no office hours or very limited hours during certain times of the year, must make its documents available during those periods when office hours are limited or not available as though it were an organization without a permanent office.[33]

E. Rules for Copies

1. Same-Day Turn-Around for In-Person Requests

If a request for copies is made in person at an organization's principal, regional, or district office during regular business hours, the organization ordinarily must provide the copies on the day the request is made.[34] If unusual circumstances exist such that fulfilling the request on the same business day places an unreasonable burden on the organization, the organization must provide the copies no later than (i) the next business day following the day the that the unusual circumstances exist; or (ii) the fifth business day after the date of the request, whichever occurs first.[35] "Unusual circumstances" include, but are not limited to:

- Receipt of a volume of requests that exceeds the organization's daily capacity to make copies;
- Requests received shortly before the end of regular business hours that require an extensive amount of copying; and
- Requests received on a day when the organization's managerial staff capable of fulfilling the request is conducting special duties, such as student registration or attending an off-site meeting or convention, rather than significant administrative duties.[36]

2. 30-Day Turn-Around for Other Requests

An organization must honor a written request for a copy of documents if the request:

- Is addressed to, and delivered by mail, electronic mail, facsimile, or a private delivery service to, a principal, regional, or district office of the organization; and
- Sets forth the address to which the copy of the documents should be sent.[37]

An organization receiving a written request must mail the copy of the requested documents within 30 days from the date it receives the request.[38] However, if the organization requires payment in advance, it is only required to

[28] *Id.*
[29] *Id.*
[30] Treas. Reg. §301.6104(d)-1(c)(2).
[31] *Id.*
[32] *Id.*
[33] *Id.*
[34] Treas. Reg. §301.6104(d)-1(d)(1)(i).
[35] Treas. Reg. §301.6104(d)-1(d)(1)(ii).
[36] *Id.*
[37] Treas. Reg. §301.6104(d)-1(d)(2)(i).

provide copies within 30 days from the day it receives payment.[39] In the absence of evidence to the contrary, a request or payment that is mailed is deemed to be received by an organization seven days after the date of the postmark.[40] A request that is transmitted to the organization by electronic mail or facsimile is deemed to be received the day the request is transmitted successfully.[41] If an organization requiring payment in advance receives a written request without payment or with insufficient payment, the organization must, within seven days from the date it receives the request, notify the requester of its prepayment policy and the amount due.[42] A copy is deemed provided on the date of the postmark or private delivery mark (or if sent by certified or registered mail, the date of registration or the date of the postmark on the sender's receipt).[43] If an individual making a request consents, the organization may provide a copy of the requested document exclusively by electronic mail.[44] In such case, the material is provided on the date the organization successfully transmits the electronic mail.

3. Copies of Parts of Documents

An organization must fulfill a request for a copy of the organization's entire application for tax exemption or annual return or any specific part or schedules of its application or return.[45] A request for a copy of less than the entire application or less than the entire return must specifically identify the requested part or schedule.

4. Use of Agents

A principal, regional, or district office may retain an agent to process requests for copies of its documents.[46] For in-person requests, an agent must be "local" and located within reasonable proximity of the applicable office.[47] A local agent that receives an in-person request for copies must provide the copies within the time limits and under the conditions that apply to the organization itself.[48] For example, a local agent generally must provide a copy to a requester on the day the agent receives the request.[49] When a principal, regional, or district office receives a request made in person, it must immediately provide the name, address, and telephone number of the local agent to the requester.[50] If an organization received a written request for copies before the agent, the deadline for providing a copy is determined by reference to when the organization received the request, not when the agent received the request.[51] An organization that provides the required information about the agent (in the case of an in-person request) or that transfers a request to the agent (in the case of a written request) is not required to respond further to the requester.[52] However, the organization still is subject to penalty provisions if the organization's agent fails to provide the documents that are required under I.R.C. §6104.[53]

5. Fees for Copies

An organization may charge a reasonable fee for copies. A fee is "reasonable" only if it is no more than the total of the applicable per-page copying fee schedule under the Freedom of Information Act (FOIA) and the actual postage costs incurred by the organization to send the copies.[54] The applicable per-page copying charge is determined without regard to any applicable fee exclusion provided in the fee schedule for an initial or de minimis number of

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[38] Treas. Reg. §301.6104(d)-1(d)(2)(ii)(A).
[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] *Id.*
[45] Treas. Reg. §301.6104(d)-1(d)(2)(ii)(B).
[46] Treas. Reg. §301.6041(d)-1(d)(1)(iii); (2)(ii)(C).
[47] Treas. Reg. §301.6041(d)-1(d)(1)(iii).
[48] *Id.;* Treas. Reg. §301.6041(d)-1(d)(2)(ii)(C).
[49] *Id.*
[50] *Id.*
[51] Treas. Reg. §301.6041(d)-1(d)(2)(ii)(C).
[52] Treas. Reg. §301.6041(d)-1(d)(1)(iii); (2)(ii)(C).
[53] *Id.*
[54] Treas. Reg. §301.6041(d)-1(d)(3)(i).

pages (e.g., the first 100 pages).[55] An organization may require that the requester pay the fee before it provides copies of the documents.[56] If the organization has provided an individual making a request with notice of the fee, and the individual does not pay the fee within 30 days, or if the individual pays the fee by check and the check does not clear upon deposit, the organization may disregard the request.[57]

If an organization does not require prepayment and a requester does not enclose payment with a request, an organization must receive consent from a requester before providing copies for which the fee charged for copying and postage exceeds $20.[58] In order to facilitate a requester's ability to receive copies promptly, an organization must respond to any questions from potential requesters concerning its fees for copying and postage.[59]

6. Forms of Payment

If an organization charges a fee for copying, it must accept payment by cash and money order for requests made in person.[60] It may accept other forms of payment such as credit cards and personal checks.[61] If an organization charges a fee for copying and postage, it must accept payment by certified check, money order, and either personal check or credit card for requests made in writing. The organization may accept other forms of payment.[62]

7. Exception When Documents are "Widely Available"

An organization is not required to comply with a request for a copy of its application for tax-exemption or an annual information return if the organization has made the document "widely available."[63] A document can be made "widely available" by posting on the organization's webpage, or by having the document posted as part of a database of similar documents of other tax-exempt organizations on a webpage established and maintained by another entity (such as Guidestar).[64] A document is considered "widely available" only if:

- The webpage through which the document is available clearly informs readers that the document is available and provides instructions for downloading it;
- The document is posted in a format that when accessed, downloaded, viewed, and printed in hard copy, exactly reproduces the image of the document that was filed with the Internal Revenue Service, except for any information permitted by statute to be withheld from public disclosure; and
- Any individual with access to the internet can access, download, view, and print the document without special computer hardware or software required for that format (other than free software available to the public) and without payment of a fee to the tax-exempt organization or to another entity maintaining the webpage.[65]

In order for a document to be "widely available" through an internet posting, the entity maintaining the webpage must have procedures for ensuring the reliability and accuracy of the document that it posts on the page and must take reasonable precautions to prevent alteration, destruction, or accidental loss of the document when posted on its webpage.[66] In the event the document is altered, destroyed, or lost, the entity must correct or replace the document. If an organization has made its applicable for tax exemption and/or an annual information return widely available, it must notify any individual requesting a copy where the documents are available (including the web address, if

[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] Treas. Reg. §301.6104(d)-1(d)(3)(iii).
[59] Treas. Reg. §301.6104(d)-1(d)(3)(iv).
[60] Treas. Reg. §301.6104(d)-1(d)(3)(ii)(A).
[61] *Id.*
[62] Treas. Reg. §301.6104(d)-1(d)(3)(ii)(B).
[63] Treas. Reg. §301.6104(d)-2(a). This exception does not affect the requirement that the documents be available for public inspection. *Id.*
[64] Treas. Reg. §301.6104(d)-2(b)(2)(i).
[65] *Id.*
[66] Treas. Reg. §301.6104(d)-2(b)(2)(iii).

applicable).[67] If the request is made in person, the organization must provide the notice immediately. If the request is made in writing, the notice must be provided within 7 days of receiving the request.

F. Exceptions to Disclosure Requirements

Notwithstanding the fact that an organization must make its exemption application and annual returns available for public inspection, certain information is not required to be disclosed:

- In the case of a tax-exempt organization other than a private foundation, the name and address of any contributor to the organization;
- Any information that was withheld by the Internal Revenue Service from inspection at the Internal Revenue Service national office under I.R.C. §6104(a)(1)(D) (which provides for withholding from public inspection any information relating to a trade secret, patent, process, style of work, or apparatus of the organization if the Internal Revenue Service determines that public disclosure of the information would adversely affect the organization.[68]

G. Whistleblowers

In an organization denies an individual's request for inspection or a copy of an application for tax exemption or an annual information return as required under I.R.C. §6104(d), and the individual wants to alert the Internal Revenue Service to the possible need for enforcement action, the individual may provide a statement to the district director for the key district in which the applicable tax-exempt organization's principal office is located (or such other person as the Commissioner may designate) that describes the reason why the individual believes the denial was in violation of the requirements of I.R.C. §6104(d).[69]

H. Harassment Protection

Upon the Internal Revenue Service's determination that an organization is the subject of a "harassment campaign" and that compliance with the requests that are part of the harassment campaign would be in the public interest, the organization is not required to fulfill a request for a copy that it reasonably believes is part of the campaign.[70]

1. Identifying "Harassment"

A group of requests for an organization's application for tax exemption or annual information returns is indicative of a harassment campaign if the requests are part of a single coordinated effort to disrupt the operations of the organization, rather than to collect information about the organization.[71] Whether a group of requests constitutes a harassment campaign depends on the relevant facts and circumstances, including:

- A sudden increase in the number of requests;
- An extraordinary number of requests made through form letters or similarly-worded correspondence;
- Evidence of a purpose to deter significantly the organization's employees or volunteers from pursuing the organization's exempt purpose;
- Requests that contain language hostile to the organization;
- Direct evidence of bad faith by organizers of the purported harassment campaign;
- Evidence that the organization has already provided the requested documents to a member of the purported harassing group; and

[67] Treas. Reg. §301.6104(d)-2(d).
[68] I.R.C. §6104(d)(3)(A),(B).
[69] Treas. Reg. §301.6104(d)-1(h).
[70] Treas. Reg. §301.6104(d)-3(a).
[71] Treas. Reg. §301.6104(d)-3(b).

- A demonstration by the organization that it routinely provides copies of its documents upon request.[72]

Example 1 (Not Harassment): ABC Charity receives an average of 25 requests per month for copies of its three most recent information returns. In the last week of May, ABC Charity was mentioned in a national news magazine story that discusses information contained in ABC Charity's most recently-filed information return. Over the month of June, ABC Charity receives 200 requests for a copy of the return. Other than the sudden increase in the number of requests for copies, there is no other evidence to suggest that the requests are part of an organized campaign to disrupt ABC Charity's operations. Although fulfilling the requests will place a burden on ABC Charity, the facts and circumstances do not show that ABC Charity is subject to a harassment campaign. Therefore, ABC Charity must respond timely to each of the 200 requests it receives in June.[73]

Example 2 (Not Harassment): The Freedom Fund is a tax-exempt organization that receives an average of 10 requests a month for copies of its annual information returns. From March 1 to March 31, The Freedom Fund receives 25 requests for copies of its documents. Fifteen of the requests come from individuals who The Freedom Fund knows to be active members of the board of organization Americans for Liberty. In the past Americans for Liberty has opposed most of the positions and policies that The Freedom Fund advocates. None of the requesters have asked for copies of documents from The Freedom Fund during the past year. The Freedom Fund has no other information about the requesters. Although the facts and circumstances show that some of the individuals making requests are hostile to The Freedom Fund, they do not show that the individuals have organized a campaign that will place enough of a burden on The Freedom Fund to disrupt its activities. Therefore, The Freedom Fund must respond to each of the 25 requests it receives in March.[74]

Example 3 (Potential Harassment). The facts are the same as in Example 2, except that during March, The Freedom Fund receives 100 requests. In addition to the fifteen requests from members of organization Americans for Liberty's board, 75 of the requests are similarly worded form letters. The Freedom Fund discovers that several individuals associated with Americans for Liberty have urged the Americans for Liberty's members and supporters, via the Internet, to submit as many requests for a copy of The Freedom Fund's annual information returns as they can. The message circulated on the Internet provides a form letter that can be used to make the request. Both the appeal via the Internet and the requests for copies received by The Freedom Fund contain hostile language. During the same year, but before the 100 requests were received, The Freedom Fund provided copies of its annual information returns to the headquarters of Americans for Liberty. The facts and circumstances show that the 75 form letter requests are coordinated for the purpose of disrupting The Freedom Fund's operations, and not to collect information that has already been provided to an association representing the requesters' interests. Thus, the fact and circumstances show that The Freedom Fund is the subject of an organized harassment campaign. To confirm that it may disregard the 90 requests that constitute the harassment campaign, The Freedom Fund must apply to the applicable district director (or such other person as the Commissioner may designate) for a determination. The Freedom Fund may disregard the 90 requests while the application is pending and after the determination is received. However, it must respond within the applicable time limits to the 10 requests it received in March that were not part of the harassment campaign.[75]

Example 4 (Media Request): The facts are the same as in Example 3, except that The Freedom Fund receives five additional requests from five different representatives of the news media who in the past have published articles about The Freedom Fund. Some of these articles were hostile to The Freedom Fund. Normally, the Internal Revenue Service will not consider a tax-exempt organization to have a reasonable belief that a request from a member of the news media is part of a harassment campaign absent additional facts that demonstrate that the organization could reasonably believe the particular requests from the news media to be part of a harassment campaign. Thus, absent such additional facts, The Freedom Fund must respond within the applicable time limits to the five requests that it received from representatives of the news media.[76]

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[72] *Id.*
[73] Treas. Reg. §301.6104(d)-3(f) *Example 1.*
[74] Treas. Reg. §301.6104(d)-3(f) *Example 2.*
[75] Treas. Reg. §301.6104(d)-3(f) *Example 3.*
[76] Treas. Reg. §301.6104(d)-3(f) *Example 4.*

2. Multiple Requests from a Single Individual or Address

An organization may disregard any request for copies of all or part of any document beyond the first two received within any 30-day period, or the first four received within any one-year period from the same individual or same address, regardless of whether the Internal Revenue Service has determined that the organization is subject to a "harassment campaign."[77]

III. STATE DISCLOSURE REQUIREMENTS

In addition to the federal disclosure requirements that apply to organizations exempt under I.R.C. §501(a), a Texas nonprofit corporation also must comply with certain state-law disclosure requirements.

A. Texas Public Information Act

The primary purpose of the Texas Public Information Act[78] ("TPIA") is to grant the people access to information "so that they may retain control over the instruments they have created."[79] TPIA is liberally construed to implement this policy.[80] TPIA does not prohibit a governmental body or its public information officer from voluntarily making part or all of its information available to the public, unless the disclosure is expressly prohibited by law or the information is confidential under law.[81] Public information made available voluntarily must be made available to any person.[82]

1. What is "Public Information"?

Public information is information that is collected, assembled, or maintained under a law or ordinance or in connection with the transaction of official business, either (i) by a governmental body; (ii) for a governmental body, if the governmental body owns the information, has the right to access the information, or spends or contributes public money for the purpose of writing, producing, collecting, assembling, or maintaining the information; or (iii) by an individual officer or employee of a governmental body in the officer's or employee's official capacity, if the information pertains to official business of the governmental body.[83] Categories of public information are listed at **Exhibit A.** However, the specific statutory categories of public information do not limit the broad definition of public information in TPIA.[84]

The term "governmental body" can refer to non-governmental entities, including a nonprofit corporation that is eligible to receive funds under the federal community services block grant program and that is authorized by the state of Texas to serve a geographic area of the state.[85] It also includes the part, section, or portion of an organization, corporation, commission, committee, institution, or agency that spends or that is supported in whole or in part by funds of the state or of a governmental subdivision of the state.[86]

The Texas Supreme Court has defined "'supported in whole or part by public funds' to include only those private entities or their sub-parts sustained, at least in part, by public funds, meaning they could not perform the same or similar services without the public funds."[87] Thus, this provision applies only to those private entities that are

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[77] Treas. Reg. §301.6104(d)-3(c).
[78] Tex. Gov. Code §552.001 et seq.
[79] *Dominguez v. Gilbert*, 48 S.W.3d 789.
[80] Tex. Gov. Code §552.001(b).
[81] Tex. Gov. Code §552.007(a).
[82] Tex. Gov. Code §552.007(b).
[83] Tex. Gov. Code §552.002(a).
[84] *City of Garland v. Dallas Morning News*, 22 S.W.3d 351. (Tex. 2000).
[85] Tex. Gov. Code §552.003(1)(A)(xi).
[86] Tex. Gov. Code §552.003(1)(A)(xii), (5).
[87] *Greater Houston P'ship v. Paxton*, No. 13-0745, 2015 WL 3978138, at *9 (Tex. June 26, 2015), cited in Texas Attorney General, "Public Information Handbook 2016" at 8, *available at* https://www.texasattorneygeneral.gov/files/og/publicinfo_hb.pdf.

dependent on public funds to operate as a going concern, and only those entities acting as the functional equivalent of the government.[88]

An entity receiving public funds is treated as a governmental body (1) unless the private entity's relationship with the government imposes a specific and definite obligation to provide a measurable amount of service in exchange for a certain amount of money as would be expected in a typical arms-length contract for services between a vendor and purchaser; (2) if the private entity's relationship with the government indicates a common purpose or objective or creates an agency-type relationship between the two; or (3) if the private entity's relationship with the government requires the private entity to provide services traditionally provided by governmental bodies.[89]

A property owners' association is subject to TPIA in the same manner as a governmental body if certain conditions are met (See **Exhibit B**).[90] The governing body of a public retirement system is subject to TPIA in the same manner as a governmental body.[91] A campus police department of a private institution of higher education is a law enforcement agency and a governmental body for purposes of TPIA only with respect to information relating solely to law enforcement activities.[92]

Information is in connection with the transaction of official business if the information pertains to official business of the governmental body and is created by, transmitted to, received by, or maintained by (i) an officer or employee of the governmental body in the officer's or employee's official capacity; or (ii) a person or entity performing official business or a governmental function on behalf of a governmental body.[93] "Official business" means any matter over which a governmental body has any authority, administrative duties, or advisory duties.[94] These rules take into account the use of electronic devices and cellular phones by public employees and officials in the transaction of official business. TPIA does not distinguish between personal and employer-issued devices; it focuses on the nature of the communication or document. If the information was created, transmitted, received, or maintained in connection with the transaction of "official business," the information constitutes public information subject to disclosure under TPIA.[95]

Public information can exist in a variety of formats, including paper; film; a magnetic, optical solid state, or other device that can store an electronic signal; tape; Mylar; and any physical material on which information can be recorded, including linen, silk, and vellum.[96] The term "public information" applies to and includes any electronic communication created, transmitted, received, or maintained on any device if the communication is in connection with the transaction of official business.[97] Thus, public information can exist in books, papers, letters, documents, emails, Internet postings, text messages, instant messages, other electronic communications, printouts, photographs, films, tapes, microfiches, microfilms, photostats, sound recordings, maps, drawings, voice data, and video representations.[98]

2. Requests for Public Disclosure

Generally, a request for information does not need to reference TPIA or be addressed to the organization's public information officer.[99] (The chief administrative officer of a governmental body is the public information officer.[100]) A written communication that reasonably can be considered to be a request for public information is a request for

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[88] *Id.*
[89] *Texas Ass'n of Appraisal Districts, Inc. v. Hart (App. 3 Dist. 2012) 382 S.W.3d 587.*
[90] Tex. Gov. Code §552.0036.
[91] Tex. Gov. Code §552.0038.
[92] Texas Educ. Code §51.212(f) (added by Act of May 21, 2015, 84th Leg., R.S., S.B. 308).
[93] Tex. Gov. Code §552.002(a-1).
[94] Tex. Gov. Code §552.003(2-a).
[95] Texas Attorney General, "Public Information Handbook 2016," *supra* at 16-17.
[96] Tex. Gov. Code §552.002(b).
[97] Tex. Gov. Code §552.002(a-2).
[98] Tex. Gov. Code §552.002(c).
[99] *See* Open Records Decision Nos. 497 at 3 (1988), 44 at 2 (1974).
[100] Tex. Gov. Code §552.201(a).

information under TPIA.[101] However, a request made by electronic mail or fax must be sent to the public information officer or the officer's designee.[102] A governmental body must make a good faith effort to relate a request to information that it holds.[103] A governmental body may ask a requestor to clarify a request for information if the request is unclear.[104] If a large amount of information has been requested, the governmental body may discuss with the requestor how the scope of the request might be narrowed, but the governmental body may not inquire into the purpose for which information will be used.[105]

A request for information is considered withdrawn if the requestor does not respond in writing to a governmental body's written request for clarification or additional information within 61 days.[106] The governmental body's written request for clarification or additional information must include a statement as to the consequences of the failure by the requestor to timely respond.[107] If the requestor's original request for information was sent by electronic mail, a governmental body may consider the request for information withdrawn if the governmental body sends its request for clarification to the electronic mail address from which the original request was sent or another electronic mail address, and the governmental body does not receive a timely written response or response by electronic mail from the requestor.[108] If the requestor's original request for information was not sent by electronic mail, a governmental body may consider the request for information withdrawn if the governmental body sent its request for clarification by certified mail to the requestor's physical or mailing address, and the governmental body does not receive a timely written response from the requestor.[109] When a governmental body, acting in good faith, requests clarification or narrowing of an unclear or overbroad request, the ten business day period to request an attorney general ruling is measured from the date the requestor responds to the request for clarification or narrowing.[110]

TPIA applies only to information that already exists,[111] so a governmental body does not need to create or prepare new information in response to a request. Further, TIPA does not require a governmental body to inform a requestor if the requested information comes into existence after the request has been made.[112]

TPIA prohibits a governmental body from inquiring into a requestor's reasons or motives for requesting information,[113] and a governmental body must treat all requests for information uniformly.[114]

Upon receipt of a request, the public information officer of a governmental body must promptly produce public information for inspection, duplication, or both.[115] "Promptly" means as soon as possible under the circumstances, that is, within a reasonable time, without delay.[116] The Attorney General acknowledges that "it is a common misconception that a governmental body may wait ten business days before releasing the information."[117] In reality, the ten-day period is not a safe-harbor. What constitutes a reasonable amount of time depends on the facts in each case, including the volume of information requested.[118]

The officer can comply with the disclosure requirement by:

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[101] Open Records Decision No. 44 at 2 (1974).
[102] Tex. Gov. Code §552.301(c).
[103] Open Records Decision No. 561 at 8 (1990).
[104] Tex. Gov. Code §552.222(b).
[105] *Id.*
[106] Tex. Gov. Code §522.222(d).
[107] Tex. Gov. Code §552.222(e).
[108] Tex. Gov. Code §552.222(g).
[109] Tex. Gov. Code §552.222(f).
[110] *City of Dallas v. Abbott*, 304 S.W.3d 380, 387 (Tex. 2010).
[111] *See* Tex. Gov. Code §§552.002, .021, .227, .351.
[112] Open Records Decision No. 452 at 3 (1986).
[113] Tex. Gov. Code §552.222.
[114] Tex. Gov. Code. §552.223.
[115] Tex. Gov. Code §552.221(a).
[116] *Id.*
[117] Texas Attorney General, "Public Information Handbook 2016," *supra* at 22.
[118] Open Records Decision No. 467 at 6 (1987).

- Providing the public information for inspection or duplication in the offices of the governmental body;

- Sending copies of the public information by first class United States mail if the person requesting the information requests that copies be provided and pays the postage and any other applicable charges that the requestor has accrued under Subchapter F of TIPA;[119] or

- Referring the requestor to an exact Internet location or uniform resource locator (URL) address on a website maintained by the political subdivision and accessible to the public if the requested information is identifiable and readily available on that website. If the person requesting the information prefers a manner other than access through the URL, the political subdivision must supply the information by one of the other two methods.[120] Further, an e-mail providing the URL must contain a statement in a conspicuous font clearly indicating that the requestor may nonetheless access the requested information by inspection or duplication or by receipt through United States mail.[121]

Generally, if a requestor chooses to inspect the public information, he or she must complete the inspection within ten business days after the date the governmental body makes the information available, or the request will be withdrawn by operation of law.[122] However, a governmental body is required to extend the inspection period upon receiving a written request for additional time.[123] If the information is needed by the governmental body, the public information officer may interrupt a requestor's inspection of the information.[124]

If the requested information is unavailable at the time of the request to examine because it is in active use or in storage, the officer for public information must certify this fact in writing to the requestor and set a date and hour within a reasonable time when the information will be available for inspection or duplication.[125] A number of Open Records Opinions discuss when information is in "active use:"[126]

- Open Records Decision No. 225 (1979): a secretary's handwritten notes are in active use while the secretary is typing minutes of a meeting from them.
- Open Records Decision No. 148 (1976): a faculty member's file is not in active use the entire time the member's promotion is under consideration.
- Open Records Decision No. 96 (1975): directory information about students is in active use while the notice required by the federal Family Educational Rights and Privacy Act of 1974 is being given.
- Open Records Decision No. 57 (1974): a file containing student names, addresses, and telephone numbers is in active use during registration.

If an officer for public information cannot produce public information for inspection or duplication within 10 business days after the date the information is requested, the officer must certify that fact in writing to the requestor and set a date and hour within a reasonable time when the information will be available for inspection or duplication.[127]

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[119] Tex. Gov. Code §552.221(b).
[120] Tex. Gov. Code §552.221(b-1).
[121] Tex. Gov. Code §552.221(b-2).
[122] Tex. Gov. Code *§552.225(a); see also Open Records Decision No. 512 (1988) (*statutory predecessor to Tex. Gov. Code §552.225 did not apply to requests for copies of public information or authorize governmental body to deny repeated requests for copies of public records*), cited in* Texas Attorney General, "Public Information Handbook 2016," *supra* at 25.
[123] Tex. Gov. Code §*552.225(b).*
[124] Tex. Gov. Code §*552.225(c).*
[125] Tex. Gov. Code §552.221(c).
[126] Texas Attorney General, "Public Information Handbook 2016," *supra* at 22-23.
[127] Tex. Gov. Code §552.221(d).

3. Exceptions to Public Disclosure

Subchapter C of TPIA[128] sets out a number of exceptions to the public disclosure requirements. The exceptions fall into two categories: "mandatory exceptions," which protect information that is confidential by law and that a governmental body is prohibited from releasing subject to criminal penalties;[129] and "permissive exceptions," which give the governmental body the discretion to either release or withhold the information.

The mandatory exceptions that might be most likely to apply to nonprofit organizations that constitute governmental bodies include:

- Information that is confidential by constitutional or statutory law or judicial decision (such as employment records, medical and health records, reports, records and working papers used or developed in an investigation of alleged child abuse or neglect, etc.);[130]
- Information in a personnel file;[131]
- Certain trade secrets and commercial and financial information;[132]
- Student records;[133]
- Certain addresses, telephone numbers, Social Security Numbers, and personal family information;[134]
- Credit card, debit card, charge card, and access device numbers;[135]
- Email addresses of members of the public that are provided for the purpose of communicating electronically with the governmental body;[136] and
- Family violence shelter center and sexual assault program information.[137]

Mandatory exceptions are not waivable.

The permissive exceptions that might be most likely to apply to nonprofit organizations that constitute governmental bodies include:

- Information related to competition or bidding;[138]
- Information related to the location or price of property;[139]
- Memoranda or letters that would not be available by law to a party in litigation with the agency;[140]
- A test item developed by an educational institution that is funded wholly or in part by state revenue or by a licensing agency or governmental body.[141]

The permissive exceptions do not require the requested information to be withheld, so the governmental body can choose not to raise a permissive exception and to release the information to the public. A governmental body's failure to comply with the requirements to request an Attorney General's decision on whether a permissive exception applies may constitute a waiver of the exception.[142]

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[128] Tex. Gov. Code §552.101 *et seq.*
[129] Tex. Gov. Code §552.352
[130] Tex. Gov. Code §552.101.
[131] Tex. Gov. Code §552.102.
[132] Tex. Gov. Code §552.110.
[133] Tex. Gov. Code §552.114.
[134] Tex. Gov. Code §552.117.
[135] Tex. Gov. Code §552.136.
[136] Tex. Gov. Code §552.137.
[137] Tex. Gov. Code §552.138.
[138] Tex. Gov. Code §552.104.
[139] Tex. Gov. Code §552.105.
[140] Tex. Gov. Code §552.111.
[141] Tex. Gov. Code §552.122.
[142] Tex. Gov. Code §552.302; *Hancock v. State Bd. of Ins*., 797 S.W.2d 379 (Tex. App.—Austin 1990, no writ).

4. Requests for Attorney General Decisions

A governmental body that wishes to withhold information from public disclosure under one of the exceptions must ask for a decision from the Attorney General about whether the information is within that exception if there has not been a previous determination about whether the information falls within one of the exceptions.[143]

Within 10 business days of receiving the request for information, the governmental body must ask for an Attorney General decision and state which exceptions apply to the information.[144] The governmental body must provide to the requestor a written statement that the governmental body wishes to withhold the requested information and that the governmental body has asked for an Attorney General decision[145] and must provide a copy of its written communication to the Attorney General in which it asks for a decision.[146] If the governmental body's written communication to the Attorney General discloses the requested information, a redacted copy must be provided.

If the information involves another party's personal or property interests, the governmental body must make a "good faith attempt" to notify the affected parties in writing, in a the form prescribed by the Attorney General.[147]

Within 15 business days of receiving the request for information, the governmental body must submit to the Attorney General:

- Written comments stating why the stated exceptions apply (with a copy to the requestor).[148]
- A copy of the written request.[149]
- A signed statement stating the date the request for information was received by the governmental body or evidence sufficient to establish the date the request was received.[150]
- Copies of the documents at issue or a representative sample of the documents at issue, labeled to indicate which exceptions apply to which parts of the documents.[151]

A governmental body's duty to request a ruling that an exception applies arises only after it receives a written (not verbal) request for information.[152] "Writing" includes electronic mail.[153]

5. The Attorney General's Practical Tips on Writing Effective Briefs to the Open Records Division[154]

- Consult The Public Information Handbook[155] and follow the standards set forth in the Handbook to meet the requirements of the claimed exceptions. For example, if claiming exception under TPIA §552.103 (the "litigation exception"), explain how the litigation is either pending or reasonably anticipated AND how the documents at issue relate to the pending or anticipated litigation.
- Be sure to explain everything in the briefing. Assume the audience knows absolutely nothing about the situation at hand. If it is not abundantly clear, accurately and adequately describe the submitted documents. For example, how are these documents responsive to the instant request for information? Who are the parties described in the documents? What is their relationship to the governmental body? If claiming that any of the documents are privileged under either the attorney-client or work product privileges, explain whether or not any of the parties are attorneys for the governmental body.

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[143] Tex. Gov. Code §552.301(a).
[144] Tex. Gov. Code §552.301(b).
[145] Tex. Gov. Code §552.301(d)(1).
[146] Tex. Gov. Code §552.301(d)(2).
[147] Tex. Gov. Code §552.305(d).
[148] Tex. Gov. Code §552.301(e)(1)(A), (e-1).
[149] Tex. Gov. Code §552.301(e)(1)(B).
[150] Tex. Gov. Code §552.301(e)(1)(C).
[151] Tex. Gov. Code §552.301(e)(1)(D), (2).
[152] Open Records Decision No. 304 at 2 (1982).
[153] Tex. Gov. Code §552.301.
[154] Taken from https://texasattorneygeneral.gov/og/open-government.
[155] *Available at* https://www.texasattorneygeneral.gov/files/og/publicinfo_hb.pdf.

- Do not redact the documents submitted for review. The Open Records Division must be able to read them if it is to rule on them.
- Provide adequate background information on the governmental body and the documents submitted. If not clear, explain how the submitted documents are responsive to the request for information. Explain what, if anything, has already been released to the requestor.
- Proofread all correspondence. Have someone else re-read the submission for minor clerical or typographical errors. Make sure section numbers for claimed exceptions are typed correctly (*e.g.*, 552.103 vs. 552.130). Also check for incorrectly-typed names, dates, and spelling errors.
- Mark all submissions clearly, carefully, and consistently. Make sure the exhibit numbers on the documents match up with the exhibit numbers in the brief. Reference previous correspondence with Open Records Division office on all future, related correspondence.
- Be sure to comply with the deadlines required under TIPA §§552.301 and 552.305

B. Member's Right to Inspect Books and Records[156]

A member of a nonprofit corporation, on written demand stating the purpose of the demand, is entitled to examine and copy at the member's expense, in person or by agent, accountant, or attorney, at any reasonable time and for proper purpose, the books and records of the corporation relevant to that purpose.[157]

Regarding the definition of "books and records," Texas law requires a nonprofit corporation to maintain:

- Books and records of accounts;
- Minutes of the proceedings of the members or the governing authority of the entity and committees of the members or the governing authority of the entity;
- At its registered office or principal place of business, or at the office of its transfer agent or registrar, a current records of the name and mailing address of each member of the entity.[158]

Courts have recognized that the statute is not absolute in its disclosure requirements. For example, the statutory right of inspection does not trump the attorney-client privilege.[159] Orders to protect confidential information are proper in requests made under the statute, and a member's own right to inspect and copy books and records does not trump privileges or other rights to confidentiality provided by Texas law.[160] However,

> in the absence of a showing that the right of inspection has been used by a member for harassment or to impede the management of the corporation, the right of inspection is not limited in number and certainly not to only one inspection…
>
> The furnishing of a financial statement of the corporation in lieu of the original financial records…is not sufficient to satisfy a right to inspect the corporate books.[161]

C. Financial Records Required to be Kept

Section 22.352(a) of the Texas Business Organizations Code ("TBOC") provides that a nonprofit corporation "shall maintain current and accurate financial records with complete entries as to each financial transaction of the corporation, including income and expenditures, in accordance with generally accepted accounting principles." Further, TBOC §22.352(b) requires the corporation's board of directions to:

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[156] The author gratefully acknowledges the significant contribution to this portion of the article made by Nicola Toubia of Fuentes Toubia, PLLC, Houston, Texas.

[157] Tex. Bus. Org. Code §22.351.

[158] Tex. Bus. Org. Code §3.151(a).

[159] *Huie v. DeShazo*, 922 S.W.2d 920, 924 (Tex. 1996).

[160] *Gaughan v. National Cutting Horse Ass'n,* 351 S.W.3d 408, 416 (Tex.App.—Ft. Worth 2011, pet. denied).

[161] *Citizens Ass'n for Sound Energy v. Bolz,* 886 S.W.2d 283, 290 (Tex.App.—Amarillo 1994, writ denied).

annually prepare or approve a financial report for the corporation for the preceding year. The report must conform to accounting standards as adopted by the American Institute of Certified Public Accountants and must include:

(1) A statement of support, revenue and expenses;
(2) A statement of changes in fund balances;
(3) A statement of functional expenses; and
(4) A balance sheet for each fund.

D. Public Disclosure of Financial Information

Section 22.353 of the TBOC sets forth a nonprofit corporation's obligation to make its financial information available to the general public. In particular, it provides that:

(a) A corporation shall keep records, books, and annual reports of the corporation's financial activity at the corporation's registered or principal office in this state for at least three years after the close of the fiscal year.
(b) The corporation shall make the records, books and reports available to the public for inspection and copying at the corporation's registered or principal office during regular business hours. The corporation may charge a reasonable fee for preparing a copy of the record or report.

If the nonprofit corporation does not maintain a financial record, prepare an annual report, or make these documents available to the general public, then it commits a Class B misdemeanor.[162] Currently, a Class B misdemeanor would trigger a $2,000.00 fine, confinement in jail not to exceed 180 days, or both the fine and jail time.[163]

E. Exception to Public Disclosure Requirements

Section 22.355 of the TBOC provides exemptions from certain the reporting and disclosure requirements of TBOC §§22.352, 22.353, and §22.354. Specifically, those sections do not apply to:

(1) A corporation that solicits funds only from its members;
(2) A corporation that does not intend to solicit and receive and does not actually raise or receive during a fiscal year contributions in an amount exceeding $10,000 from a source other than its own membership; or
(3) Certain private or independent institutions of higher learning and related organizations.

F. Financial Records Required to be Produced

Only one recent Texas decision has analyzed the scope of TBOC §22.353 and what records a nonprofit corporation must produce.[164] In *Knapp Medical Center v. Grass*, 443 S.W.3d 182 (Tex.App.—Corpus Christi 2013, no pet.), the court considered whether the Knapp Medical Center, a hospital and Texas nonprofit corporation, met the statutory exception to the disclosure rule. Specifically, Knapp argued that it did not have to disclose any records because it fell under the exemption of TBOC §22.355(2), above.

The hospital received grants from a foundation, the sole purpose of which was to provide financial support for the hospital. The hospital did not solicit charitable contributions from the general public. The court agreed with

[162] Tex. Bus. Org. Code §22.354.
[163] Tex. Pen. Code §12.22.
[164] In *Denton County Electric Cooperative v. Hackett*, 368 S.W.3d 765 (Tex.App.-Fort Worth 2012, pet denied), a member of a nonprofit electric cooperative sued, among other things, for the cooperative to disclose certain records under the Texas Electric Cooperative Corporation Act ("ECCA"). The court noted that the ECCA does not give cooperative members the same rights as nonprofit members to inspect books and records under TBOC §22.351.

the hospital's interpretation of the statute and reasoned that the grants that the hospital received from its related foundation were not charitable contributions from the general public. Because the hospital's grants were not contributions, it met the exception of section TBOC §22.355(2). In reaching its decision, the court relied on *Texas Appellate Practice & Educ. Resource Ctr. v. Patterson*, 902 S.W.2d 686 (Tex.App.—Austin 1995, writ denied). In that case, discussed more fully below, a Texas nonprofit corporation successfully argued that grants from the government or other charitable organizations were distinguishable from contributions from the general public. Thus, the nonprofit corporation did not have to produce any of its financial records because it received all of its income from grants.

Although the court decided the *Knapp* case on a narrow exception, the opinion provides a good explanation and interpretation of TBOC §22.353. Importantly, the court construes that the plain meaning of section TBOC §22.353 requires all Texas nonprofit corporations "to keep records, books and annual reports of the nonprofit corporation's *financial activity* on file at the nonprofit corporation['s] registered or principal office for at least three years after the close of the nonprofit's fiscal year."[165] The court clarifies that section TBOC §22.353 only require that certain financial information be made available. It noted that the legislative intent behind article 1396-22.23A of the Texas Nonprofit Corporation Act, the predecessor to TBOC §22.353, was to "open the windows of transparency to nonprofit organizations who solicited money from the public by keeping financial records on file and opening those records for public inspection, if so requested."[166] The *Knapp* decision is relevant because it clarifies that TBOC §22.353 is limited to financial information.

Because there is a dearth of case law interpreting the current disclosure statute, it is important to review those cases that analyzed its predecessor statute—Article 1396-2.23A of the Texas Nonprofit Corporation Act—to determine whether the requirement to provide financial records is broad or narrow in scope. The earlier cases support a narrow meaning of financial records. Article 1396-2.23A provides:

> A. A corporation shall maintain current true and accurate *financial records* with full and correct entries made with respect to all *financial transactions* of the corporation, including all income and expenditures, in accordance with generally accepted accounting practices.
> B. Based on these records, the board of directors shall annually prepare or approve a *report of the financial activity* of the corporation for the preceding year …
> C. All records, books and annual reports *of the financial activity of the corporation* shall be kept at the registered office or principal office of the corporation in this state for at least three years after the closing of each fiscal year and shall be available to the public for inspection and copying there during normal business hours. The corporation may charge for the reasonable expense of preparing a copy of a record or report.[167]

Several courts have interpreted this statute and found that it is narrow in scope. For example, in *In re Bay Area Citizens Against Lawsuit Abuse*, 982 S.W.2d 371 (Tex. 1998), members of the general public wanted the Bay Area Citizens Against Lawsuit Abuse, a Texas nonprofit corporation ("BACALA"), to produce the names of its contributors in response to a trial court's discovery orders. BACALA did not want to disclose its contributors' names and argued that the First Amendment prohibited disclosure. The public demanding the disclosure countered that because BACALA voluntarily incorporated as a Texas nonprofit corporation, it waived any constitutional rights to protecting its contributors' identities and that article 1396-2.23A of the TNPCA required BACALA to disclose them. Although the court found—and BACALA agreed—that some financial records, such as financial statements and tax returns, are subject to disclosure, the court ruled that the statute does not require disclosure of contributors' names. In reaching this decision, the Texas Supreme Court analyzed the legislative history to article 1396-2.23A of the TNPCA and stated:

> [T]he purpose of the legislation was not to force non-profit corporations to identify the exact sources of their income; rather, it was to expose the nature of the expenditures of that money once received from the

[165] *Knapp*, *supra*, at 188(emphasis added).
[166] *Id.*
[167] Tex. Rev. Civ. Stat. Ann. art. 1396-2.23A (expired Jan. 2010) (emphasis added).

> public and to make non-profit organizations accountable to their contributions for those expenditures. Thus, the seemingly broad scope of the statute's language is not matched by the legislative intent behind the statute.[168]

The Texas Supreme Court found that the statute should be narrowly interpreted.

The appellate court for the district of Austin also found that article 1396-2.23A of the TNPCA should be narrowly interpreted.[169] In reviewing whether State Senator Patterson had access to financial records of the Texas Resource Center, the court concluded that he did not. It reasoned:

> the legislative history of Article 1396-2.23A sustains the Resource Center's narrow interpretation of the scope of the statute. Several times during the Senate hearings on S.B. 857, the bill's author, Senator Gene Jones, emphasized that the bill was a narrowly drawn law that was only meant to apply to certain non-profit corporations:
>
> > [The bill] would simply give the right of people who are considering making a contribution, the right to know that there are records kept consistent with proper accounting principles in the office of the organization soliciting those funds during business hours.[170]

The opinion continues to cite several other places in the legislative history to article 1396-2.23A of the TNPCA where Senator Jones emphasizes that the bill is "narrowly drawn."

In *Gaughan v. National Cutting Horse Association*, 351 S.W.3d 408 (Tex.App.—Fort Worth 2011 pet. denied), the appellate court also held that article 1396-2.23A of the TNPCA means that a member of the general public may only inspect the records, books and annual reports of the financial activity of the nonprofit corporation. Citing the *BACALA* decision, the appellate court said that financial records do not include the names of contributors or members and that article 1396-2.23A of the TNPCA "does not require the blanket disclosure of contributors' names for public inspection."[171] Further, it summarized, like prior cases, the purpose of the disclosure statute is to make a nonprofit corporation accountable to its contributors for expenditures of the contributions that the nonprofit corporation receives.

Moreover, the *Gaughan* court concluded that article 1396-2.23A of the TNPCA is not absolute in scope and that nonprofit corporations may seek orders to protect the confidential information that they maintain. In *Gaughan* a member of the cutting horse association sought to (1) get all of the association's books and records under article 1396-2.23;[172] and (2) disclose them to the general public under article 1396-2.23A of the TNPCA. The court was not impressed and ruled that "a member's own right to inspect and copy books and records under article 1396-2.23 does not trump privileges or other rights to confidentiality provided for by Texas law."[173] Importantly, the court found that Gaughan could not disseminate to the public either records that were covered by a protective order or those that were not financial records under article 1396-2.23A of the TNPCA.

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[168] *Bay Area Citizens, supra* at 381.

[169] *See Texas Appellate Practice and Educational Resource Center v. Patterson*, 902 S.W.2d 686 (Tex.App.—Austin 1995, *writ denied)*

[170] *Id*. at 688.

[171] *Gaughan, supra,* at 415.

[172] Article 1396-2.23 of the TNPCA is the predecessor to TBOC §22.351 and similarly gives a member of a nonprofit corporation a broader inspection right than a member of the general public so long as the member has a proper purpose for the inspection.

[173] *Gaughan, supra,* at 418.

G. Nonprofit Periodic Report

Nonprofit entities that are exempt from Texas margin tax do not have to file annual Public Information Reports with the Comptroller of Public Accounts.[174] However, the Secretary of State may require a nonprofit corporation to file a "Nonprofit Periodic Report" not more than once every four years.[175] The report must be made on the form promulgated by the Secretary of State and include:

(1) The name of the corporation;
(2) The state or country under the laws of which the corporation is incorporated;
(3) The address of the registered office of the corporation in this state and the name of the registered agent at that address;
(4) If the corporation is a foreign corporation, the address of the principal office of the corporation in the state or country under the laws of which the corporation is incorporated; and
(5) The names and addresses of the directors and officers of the corporation.[176]

Reports are not filed annually or on any regular schedule, but only upon request. The Secretary of State requests a report by sending a notice that the report is due and a copy of the proper form to the corporation's registered agent or to the corporation's last known address or known place of business.[177] The report must be filed not later than the 30th day after the notice is mailed.[178]

A corporation that fails to file its report when it is due forfeits its right to conduct affairs in Texas.[179] A corporation can be relieved of forfeiture by filing the required report, together with the revival fee, not later than the 120th day after the date of mailing of the notice of forfeiture.[180] If the corporation fails to revive its right to conduct affairs, it is subject to involuntary termination (for a domestic corporation) or revocation of its registration to transact business in Texas (for a foreign corporation).[181] In order to be reinstated, the corporation must follow the procedures set out in TBOC §22.365. If the corporation's name is not available at the time of reinstatement, the corporation must amend its corporate name.[182]

On many occasions, the author has seen nonprofit corporations be subject to forfeiture or involuntary termination because they did not receive the notice sent to the registered agent. Typically, this result occurs because the organization moved from its original registered office and failed to change its registered office on file with the Secretary of State.

IV. CONCLUSION

As a general rule, transparency is central to good governance, and organizations that are exempt from tax (and receive tax deductible contributions) have a responsibility to provide information about their operations to the general public. At the same time, an organization should protect its interests, and the interests of its stakeholders, by keeping confidential information that is not required to be disclosed or by managing the flow of information.

By understanding the applicable rules, an organization can meet its legal obligations while avoiding undue (or overly swift) disclosure. In doing so, it may be able to stave off, better manage a crisis.

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[174] *See* Tex. Tax §171.203(a) (imposing filing requirement only on entities subject to tax).
[175] Tex. Bus. Org. Code §22.357(a).
[176] Tex. Bus. Org. Code §22.357(a), (b).
[177] Tex. Bus. Org. Code §22.358.
[178] Tex. Bus. Org. Code §22.359.
[179] Tex. Bus. Org. Code §22.360(a).
[180] Tex. Bus. Org. Code §22.363(a).
[181] Tex. Bus. Org. Code §22.364(a).
[182] Tex. Bus. Org. Code §22.364(c).

Exhibit A: Categories of Public Information; Examples (Tex. Gov. Code §552.022)

Sec. 552.022. CATEGORIES OF PUBLIC INFORMATION; EXAMPLES. (a) Without limiting the amount or kind of information that is public information under this chapter, the following categories of information are public information and not excepted from required disclosure unless made confidential under this chapter or other law:

(1) a completed report, audit, evaluation, or investigation made of, for, or by a governmental body, except as provided by Section 552.108;

(2) the name, sex, ethnicity, salary, title, and dates of employment of each employee and officer of a governmental body;

(3) information in an account, voucher, or contract relating to the receipt or expenditure of public or other funds by a governmental body;

(4) the name of each official and the final record of voting on all proceedings in a governmental body;

(5) all working papers, research material, and information used to estimate the need for or expenditure of public funds or taxes by a governmental body, on completion of the estimate;

(6) the name, place of business, and the name of the municipality to which local sales and use taxes are credited, if any, for the named person, of a person reporting or paying sales and use taxes under Chapter 151, Tax Code;

(7) a description of an agency's central and field organizations, including:

(A) the established places at which the public may obtain information, submit information or requests, or obtain decisions;

(B) the employees from whom the public may obtain information, submit information or requests, or obtain decisions;

(C) in the case of a uniformed service, the members from whom the public may obtain information, submit information or requests, or obtain decisions; and

(D) the methods by which the public may obtain information, submit information or requests, or obtain decisions;

(8) a statement of the general course and method by which an agency's functions are channeled and determined, including the nature and requirements of all formal and informal policies and procedures;

(9) a rule of procedure, a description of forms available or the places at which forms may be obtained, and instructions relating to the scope and content of all papers, reports, or examinations;

(10) a substantive rule of general applicability adopted or issued by an agency as authorized by law, and a statement of general policy or interpretation of general applicability formulated and adopted by an agency;

(11) each amendment, revision, or repeal of information described by Subdivisions (7)-(10);

(12) final opinions, including concurring and dissenting opinions, and orders issued in the adjudication of cases;

(13) a policy statement or interpretation that has been adopted or issued by an agency;

(14) administrative staff manuals and instructions to staff that affect a member of the public;

(15) information regarded as open to the public under an agency's policies;

(16) information that is in a bill for attorney's fees and that is not privileged under the attorney-client privilege;

(17) information that is also contained in a public court record; and

(18) a settlement agreement to which a governmental body is a party.

(b) A court in this state may not order a governmental body or an officer for public information to withhold from public inspection any category of public information described by Subsection (a) or to not produce the category of public information for inspection or duplication, unless the category of information is confidential under this chapter or other law.

Exhibit B: Property Owners' Associations subject to TPIA (Tex. Gov. Code §552.0036)

Sec. 552.0036. CERTAIN PROPERTY OWNERS' ASSOCIATIONS SUBJECT TO LAW. A property owners' association is subject to this chapter in the same manner as a governmental body:

(1) if:

(A) membership in the property owners' association is mandatory for owners or for a defined class of owners of private real property in a defined geographic area in a county with a population of 2.8 million or more or in a county adjacent to a county with a population of 2.8 million or more;

(B) the property owners' association has the power to make mandatory special assessments for capital improvements or mandatory regular assessments; and

(C) the amount of the mandatory special or regular assessments is or has ever been based in whole or in part on the value at which the state or a local governmental body assesses the property for purposes of ad valorem taxation under Section 20, Article VIII, Texas Constitution; or

(2) if the property owners' association:

(A) provides maintenance, preservation, and architectural control of residential and commercial property within a defined geographic area in a county with a population of 2.8 million or more or in a county adjacent to a county with a population of 2.8 million or more; and

(B) is a corporation that:

(i) is governed by a board of trustees who may employ a general manager to execute the association's bylaws and administer the business of the corporation;

(ii) does not require membership in the corporation by the owners of the property within the defined area; and

(iii) was incorporated before January 1, 2006.

Note: The only county in Texas with a population of 2.8 million or more is Harris County. The counties adjoining Harris County are Waller, Fort Bend, Brazoria, Galveston, Chambers, Liberty, and Montgomery. Thus, property owners' associations located in those counties and otherwise within the parameters of section 552.0036 are considered to be governmental bodies for purposes of the Act.[183]

[183] Texas Attorney General, "Public Information Handbook 2016" at 10, *available at* https://www.texasattorneygeneral.gov/files/og/publicinfo_hb.pdf.

PRESENTED AT

State Bar of Texas Tax Section
2020 Tax Law in a Day Conference

February 7, 2020
Houston, Texas

Texas Sales and Use Tax for the Construction Industry

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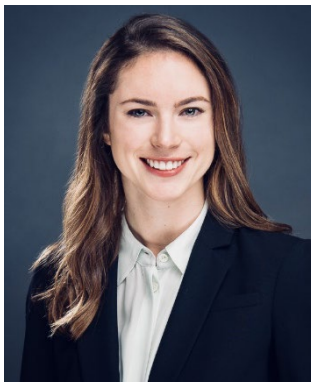

Ms. Cunningham is a Texas tax litigation attorney with Martens, Todd, Leonard & Ahlrich, a boutique tax litigation law firm located in Austin. She and other members of her firm limit their law practices to Texas sales and use tax and Texas franchise tax controversies and litigation. Ms. Cunningham is licensed by the State Bar of Texas and represents Texas tax taxpayers before the State Office of Administrative Hearings and all state trial and appellate courts. Ms. Cunningham writes and speaks on a variety of Texas tax subjects, including the Texas sales & use and franchise taxes.

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Table of Contents

I. Introduction

Proper handling of Texas sales and use tax obligations is crucial to preserving profit margins and avoiding audit headaches within the construction industry. This paper addresses the most commonly taxable items in construction projects and how contract pricing dictates when and from whom Texas sales and use tax is due. Understanding contract pricing is key to minimizing adverse audit assessments, so awareness of variances between industry and Comptroller usage of common terms—like lump-sum and separated contracts—is essential. This paper then concludes with a discussion of common pitfalls that generate Texas sales and use tax audit assessments, including mistreatment of sales tax between the bid and contract phases, over-reliance on standardized industry forms that do not adequately address Texas sales and use tax matters, and incorporation of documents into a construction contract that impacts contract pricing.

II. Texas Sales and Use Tax Principles Applicable to the Construction Industry

Although several Texas taxes apply to the construction industry, this paper limits its discussion to Texas sales and use tax. Texas Tax Code Chapter 151 imposes sales and use tax on the sale, lease or rental of tangible personal property and on certain specified services.[1] Tangible personal property is property that is touchable or moveable, and does not include real property.[2] Texas' sales and use taxes are complementary, meaning that they do not overlap, but, rather, are intended to uniformly tax transactions once, whether the taxable transaction is consummated in or outside of Texas.[3] The state sales and use tax rate is 6.25%, although various local jurisdictions

[1] *See* TEX. TAX CODE ANN. §§ 151.001–.801 (West 2015).

[2] *See* TEX. TAX CODE ANN. § 151.009 (West 2015).

[3] *Combs v. Chapal Zenray, Inc.*, 357 S.W.3d 751, 757 (Tex. App.—Austin 2011, pet. denied) ("The use tax complements the state sales tax and is designed to tax transactions not reached by the sales tax. The use tax thus applies to use or consumption in this state of property purchased outside the state. The purpose of the use tax is 'to more evenly distribute the tax burden among all consumers by imposing a tax on the fruits of an interstate purchase as well as on the sale of property in this State.' The use tax serves to prevent 'avoidance of a state's sales tax by the

may impose up to an additional 2% in local sales and use taxes.[4] The maximum possible tax rate is 8.25%.

a. Sales Tax Versus Use Tax

Texas imposes *sales* tax on sales of taxable items in Texas.[5] Thus, for example, if a construction company located in San Antonio purchases a diesel-powered backhoe from a supplier located in Houston, the construction company must pay *sales* tax on this purchase because the transaction is consummated in Texas.

In contrast, Texas imposes *use* tax when items are acquired out-of-state and brought into Texas for storage, use, or consumption.[6] Without the use tax, persons could purchase items from an out-of-state retailer, use the items in Texas, and escape paying tax.[7] The use tax prevents this abuse and places out-of-state vendors on an even playing field with Texas vendors because it removes a purchaser's incentive to shop outside of Texas to save on tax.[8] Thus, if the same San Antonio construction company purchased a backhoe from a supplier located in Tulsa, Oklahoma, the construction company would owe Texas *use* tax on its purchase and must accrue and remit the Texas use tax to the Texas Comptroller. If *sales* tax was legally-owed and paid in Oklahoma, the construction company would be entitled to a tax credit for the Oklahoma *sales* tax paid against the Texas *use* tax due.

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purchase of goods in another state, and to place retailers in the state upon equal footing with out-of-state competitors, who are not obligated to collect and remit sales tax.' In accordance with the complementary nature of the use and sales taxes, use tax is not applicable to a purchaser who has paid sales tax to a Texas retailer . . . and any exemption applicable to the sales tax applies to the use tax.") (internal citations omitted).

[4] TEX. TAX CODE ANN. §§ 151.051(b), .101(b) (West 2015); 34 Tex. Admin. Code § 3.334(a)(22) (2015).

[5] TEX. TAX CODE ANN. § 151.051(a) (West 2015).

[6] *Id*.

[7] *Combs v. Chapal Zenray, Inc.*, 357 S.W.3d 751, 757 (Tex. App.—Austin 2011, pet. denied).

[8] *Id*.

b. Taxable Items in the Construction Context

As relevant to Texas sales and use tax, construction services include all forms of real property work, such as real property improvements; new construction; and repair, remodeling, restoration, and maintenance of both residential and non-residential properties. Construction companies' services and purchases may be subject to Texas sales and use tax. This paper limits its scope to the most common taxable items (tangible personal property and certain enumerated services) in the construction context, which include:

- **Materials Incorporated into Real Estate.** Sales of tangible personal property are taxable.[9] For example, if a contractor purchases roofing material in Texas for a Texas project, the purchase is subject to the Texas sales tax.
- **Supplies Consumed at the Construction Site.** Sales of supplies to be consumed in the course of operating a business or while providing services (taxable or non-taxable) are taxable.[10] For example, if a contractor purchases paint drop cloths in Texas for use at Texas projects, the purchase is subject to Texas sales tax.
- **Equipment Used to Provide Services.** Purchases of equipment and tools used to provide services (taxable or non-taxable) are taxable.[11] For example, if a contractor purchases a hammer in Texas to construct foundation forms at a Texas job site, the purchase is subject to Texas sales tax.

[9] TEX. TAX CODE ANN. §§ 151.009, .010, .051 (West 2015).

[10] *Id*.

[11] *Id*.

- **Leased Equipment (With and Without Operators).** Leases are taxable when the underlying property, if purchased outright, would be subject to Texas sales and use tax.[12] For example, a contractor owes Texas sales tax on the monthly lease payments for a generator used to power field lighting on a Texas project. However, when taxable items, like equipment, are leased with an operator, the application of the Texas sales and use tax rules become more complex because this transaction is presumed to be the performance of a service. A service is only taxable if it falls within the finite list of services stated in Texas Tax Code Section 151.0101.
- **Real Property Services.** Charges for certain types of real property services—such as surveying, grounds cleaning, weed control, and pest control—are taxable.[13] For example, if a contractor purchases surveying services to determine Texas site boundaries, the purchase of this service is subject to Texas sales tax.
- **Non-residential (Commercial) Real Property Repairs and Remodeling.** Charges to repair or remodel non-residential (commercial) real property are taxable.[14] For example, charges to remodel a Texas office building are subject to Texas sales tax.
- **Tangible Personal Property Repairs and Remodeling.** Charges to repair or remodel most tangible personal property are taxable.[15] For example, charges to repair construction equipment are subject to Texas sales tax.

[12] TEX. TAX CODE ANN. §§ 151.005, .051 (West 2015).

[13] TEX. TAX CODE ANN. §§ 151.0101(a)(11), .0048 (West 2015).

[14] TEX. TAX CODE ANN. §§ 151.0101(a)(13), .0047 (West 2015).

[15] TEX. TAX CODE ANN. §§ 151.0101(a)(5) (West 2015).

Notably, the above list of common taxable items does not include labor charges for new construction or residential repairs and remodeling. The Comptroller, by rule, defines new construction as "all new improvements to real property, including initial finish-out work to the interior or exterior of the improvement."[16] New construction also includes the addition of new, usable square footage to an existing structure.[17] For example, adding a second floor to a one-story building without raising the roof of the first floor is new construction.[18] Whether construction work constitutes new construction is only relevant for work performed on non-residential (commercial) structures because labor charges for residential work are not taxable, whether the work is performed on new or existing structures.

c. Properly Identifying Property Types

As demonstrated by the above list of taxable items, to properly handle their Texas sales and use tax obligations, contractors must be able to distinguish tangible personal property from real property, and residential real property from commercial real property.

i. Real Versus Tangible Property

Texas law defines real property as land, including structures and other improvements embedded in or permanently affixed to the land.[19] Case law sets forth a three-factor test to distinguish real from tangible personal property: the mode and sufficiency of the annexation to realty, either real or constructive; the adaptation of the item to the use or purpose of the realty; and the intent of the party who annexed the personal property to the realty.[20] Comptroller auditors are

[16] 34 TEX. ADMIN. CODE §§ 3.291(a)(9), 3.357(a)(8) (2002).

[17] *See* 34 TEX. ADMIN. CODE §§ 3.291(a)(9), 3.357(a)(8) (2002).

[18] *See* 34 TEX. ADMIN. CODE § 3.357(a)(8) (2002)

[19] *Logan v. Mullis*, 686 S.W.2d 605, 607 (Tex. 1985); 34 TEX. ADMIN. CODE § 3.357(a)(10) (2002).

[20] *Logan v. Mullis*, 686 S.W.2d 605, 607 (Tex. 1985); *Hutchins v. Masterson & Street*, 46 Tex. 551 (1887).

trained to determine the parties' intent by reviewing contracts, authorizations for expenditures, annual reports, and other documentation.[21]

The following example illustrates the distinction between real and tangible personal property. If a property owner purchases a hot tub and installs it in a portable gazebo in his backyard, the portable nature of the gazebo may indicate an intent that the hot tub will be moved when the owner sells the house and, thus, support a characterization of the hot tub as tangible personal property. In contrast, if the property owner installs the hot tub in his bathroom during remodeling construction, the hot tub would most likely be characterized as real property due to the damage removal would cause (*e.g.*, tearing out one of the new walls).

ii. <u>Residential Versus Commercial Property</u>

The sales and use tax laws also require contractors to distinguish between residential and non-residential (commercial) real property. Residential real property is defined as property that is used as a family dwelling, multifamily apartment or housing complex, nursing home, condominium, or retirement home.[22] The term includes homeowners-association-owned and apartment-owned swimming pools, laundry rooms, and other common areas designated for tenants' use.[23] Everything else is non-residential real property.[24] Examples include: hotels, motels, hospitals, prisons, rehabilitation centers, and recreational vehicle parks.[25] Understanding

[21] TEXAS COMPTROLLER OF PUBLIC ACCOUNTS, AUDIT PROCEDURES FOR CONTRACTORS & REPAIRMEN, 1 (April 2017), *available at* https://comptroller.texas.gov/taxes/audit/docs/contractor-manual.pdf.

[22] 34 TEX. ADMIN. CODE §§ 3.291(a)(12); 3.357(a)(13) (2002).

[23] *Id.*

[24] TEXAS COMPTROLLER OF PUBLIC ACCOUNTS, Pub. No. 94-157, HOMEBUILDERS AND REAL PROPERTY SERVICES (Mar. 1, 2001), *available at* https://comptroller.texas.gov/taxes/publications/94-157.php.

[25] *Id*.

the distinctions between residential and non-residential property is important because the charge for any type of residential construction labor (new construction or repair and remodeling) is not taxable.

d. <u>The Most Commonly Applicable Exemption: Sale for Resale</u>

A variety of Texas sales and use tax exemptions may apply to a construction project; however, this paper limits its discussion to the most commonly applicable one: the resale exemption. The sale of a taxable item for resale is exempt from Texas sales and use tax.[26] A sale for resale is generally defined as a sale of a taxable item to a purchaser who acquires the item for the purpose of reselling it, in the normal course of business either in the form or condition in which it is acquired, or as an attachment to, or integral part of, other taxable items.[27] The purpose of the resale exemption is to avoid duplicative taxation.[28]

Both tangible personal property and taxable services may be purchased for resale.[29] The resale exemption is documented through a properly-completed resale certificate, which is a form promulgated by the Texas Comptroller.[30] A sale is exempt if the resale certificate is accepted in good faith and the seller lacks actual knowledge that the sale is not a sale for resale.[31]

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[26] TEX. TAX CODE ANN. § 151.302(a) (West 2015).

[27] TEX. TAX CODE ANN. § 151.006(a)(1) (West 2015).

[28] *7-Eleven, Inc. v. Combs*, 311 S.W.3d 676, 684 (Tex. App.—Austin 2010, pet. denied) ("The purpose of the sale-for-resale exemption is to prevent double taxation.").

[29] *See, e.g.,* TEX. TAX CODE ANN. § 151.006(a)(1) (West 2015).

[30] 34 TEX. ADMIN. CODE. § 3.287(h) (2018).

[31] *See* 34 TEX. ADMIN. CODE § 3.285(c)(3)(B).

III. Contract Pricing

Contract pricing terms are crucial to determining contractors' Texas sales and use tax obligations because, when the labor component of a project is non-taxable (*e.g.*, new construction or residential repair and remodeling), contract pricing dictates who the consumer of taxable items used for the project is, and, thus, who either owes the tax or may claim the resale exemption.

a. Lump-sum v. Separated

For Texas sales and use tax purposes, contract pricing terms fall into one of two categories: lump-sum or separated. A lump-sum contract is one in which the agreed contract price is one lump-sum amount and in which the charges for incorporated materials are not separated from any charges for skill and labor.[32] In contrast, a separated contract is one in which the agreed contract price is divided into a separately-stated price for incorporated materials and a separately-stated price for all skill and labor.[33] Labor includes fabrication, installation, and other labor that is performed by the contractor.[34] It is irrelevant if separately-stated prices for incorporated materials and labor are added together to state a sum total.[35]

There is a document hierarchy for determining the nature of contract pricing.[36] A written contract is king. However, in the absence of a written contract, a written bid will control. If neither a written contract nor a written bid exists, a written invoice determines tax responsibilities. Generally,

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[32] 34 TEX. ADMIN. CODE § 3.291(a)(8) (2008).

[33] 34 TEX. ADMIN. CODE § 3.291(a)(13) (2008).

[34] 34 TEX. ADMIN. CODE § 3.291(a)(8), (13) (2008).

[35] 34 TEX. ADMIN. CODE § 3.291(a)(13) (2008).

[36] TEXAS COMPTROLLER OF PUBLIC ACCOUNTS, AUDIT PROCEDURES FOR CONTRACTORS & REPAIRMEN, 5 (April 2017), *available at* https://comptroller.texas.gov/taxes/audit/docs/contractor-manual.pdf.

the controlling document takes precedence over other documents that may be provided unless the controlling document incorporates or requires other documents utilizing a different contract pricing structure, as discussed further in the Pitfalls section below. Thus, for example, a contractor who issues separated invoices to his customer will not change a lump-sum contract into a separated one unless the terms of the contract itself require the issuance of invoices separately stating the charges for labor and materials or incorporates the invoices by reference.[37]

A lump-sum contract is taxed as a service. Thus, the contractor's charge is either fully taxable or non-taxable, depending upon the nature of the labor provided.[38] For example, a lump-sum contractor building a new office building would not charge his customer Texas sales and use tax because new construction labor is not taxable and the lump-sum nature of the contract treats the contractor as providing a non-taxable new construction service. However, a separated contract treats a contractor as separately selling to his customer construction labor (which may or may not be taxable) and materials (which are taxable tangible personal property). So, if the same contractor uses, instead, a separated contract for a new construction project, the contractor would charge his customer Texas sales and use tax only on the materials charge because new construction labor is non-taxable.[39]

The taxability of a contractor's charge, then, determines the availability of the resale exemption because the exemption may only be claimed on purchases of items that the contractor resells to the customer as a taxable item—*i.e.*, tangible personal property or a taxable service.

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[37] *See e.g.* 34 TEX. ADMIN. CODE § 3.291(a)(8).

[38] 34 TEX. ADMIN. CODE § 3.291(b)(3)(A) (2008), 34 TEX. ADMIN. CODE § 3.357(b)(2) (2002).

[39] 34 TEX. ADMIN. CODE § 3.291(b)(4)(A) (2008).

Thus, contractors who provide lump-sum, taxable construction services (*e.g.*, commercial repair and remodeling) may purchase tax-free incorporated materials and taxable services that they resell to their customers through the provision of their own taxable service.[40] For example, the general contractor in a commercial remodeling project may purchase tax-free the services of a subcontractor to perform HVAC work because the subcontractor's taxable remodeling service will be resold and taxed through the general contractor's (marked-up) charge to the customer. In contrast, contractors who provide lump-sum, non-taxable construction services (*e.g.*, new construction and residential repair and remodeling) may not purchase taxable items tax-free because they do not resell them through the provision of a taxable service.[41] Finally, separated contractors may purchase tax-free incorporated materials, regardless of the taxability of their labor, because their contract pricing terms establish the sale of taxable items to the customer.

b. Reimbursements

Contractors regularly incur business expenses that they then pass on to their customers to be reimbursed on a dollar-for-dollar basis. Contract pricing, the type of work performed, and the nature of reimbursement all impact whether a contractor must collect sales tax from its customer on reimbursement charges. The Comptroller has recently issued guidance addressing the taxability of reimbursements.[42]

[40] *See* TEX. TAX CODE ANN. § 151.151 (West 2015); 34 TEX. ADMIN. CODE § 3.357(b)(2) (2002).

[41] 34 TEX. ADMIN. CODE § 3.291(b)(3)(A) (2008).

[42] *See* APPX. E.

IV. Common Pitfalls to Avoid

The following discussion of common pitfalls to avoid is based upon the authors' experience representing members of the construction industry during an audit or in litigation to challenge an adverse audit assessment.

a. The Mixed Services Rule

Contractors must be mindful of the consequences of stating a single charge for both taxable and non-taxable work. If a non-taxable service and a taxable service are purchased for a single charge, and the portion of the fee relating to the taxable service represents more than 5% of the total charge, then the entire charge is presumed taxable under the Comptroller's mixed services rule.[43] To prevent the entire charge from being treated as taxable, contractors should separately identify the charges for taxable and non-taxable work.[44]

For example, if an office owner hires a contractor to construct a new wing for an existing building, the project will include laying a foundation for the new wing and building the wing itself. To provide access to the new wing, the contractor must knock down a wall in the existing building and replace it with an archway. While the work on the new wing is clearly non-taxable new construction, the work associated with demolishing the old wall and replacing it with an archway is considered taxable commercial repair and remodeling. The parties should apportion the total contract price between these two types of work to avoid the Comptroller's use of the mixed services rule to treat the entire project as taxable.

[43] *See* 34 TEX. ADMIN. CODE § 3.357(b)(9) (2002).

[44] 34 TEX. ADMIN. CODE § 3.357 (2002); 34 TEX. ADMIN. CODE § 3.291 (2008).

b. Assessments Arising from Tax Collected in Error

Failure to use the correct contract pricing terms may result in a contractor collecting tax in error from a customer. This can lead to audit issues, such as the following two examples. First, contractors should not include contract language purporting to charge Texas sales and use tax on a non-taxable project. Because the Texas sales and use tax is a trust fund tax, all tax purported to be collected must be remitted to the Comptroller regardless of whether the transaction is actually taxable.[45] For example, if a contractor who performs taxable and non-taxable work uses a contract containing tax-included language for both project types, but only remits to the Comptroller the tax on taxable projects, the Comptroller may assess the contractor for tax collected but not remitted on the non-taxable work. The contractor will be required to back the tax out of the non-taxable contract price, causing him to lose his profit margin, likely years after the work was completed, through a Comptroller assessment of up to 8.25% in tax, plus penalty and interest, on work that is not actually taxable.[46]

Contract pricing errors may also lead to tax collected in error that cannot be used to offset the contractor's liability for tax due on purchases.[47] Say, for instance, a contractor believes he is performing new construction under a separated contract, so he claims the resale exemption on his purchase of incorporated materials and collects tax on the materials from the property owner. However, a Comptroller auditor determines that the project documents actually commingle some charges for labor and materials, so she treats the contract as lump-sum. Under a lump-sum contract

[45] *See* TEX. TAX CODE § 111.016 (West 2015).

[46] *Id*.

[47] TEXAS COMPTROLLER OF PUBLIC ACCOUNTS, AUDIT PROCEDURES FOR CONTRACTORS & REPAIRMEN, 4 (April 2017), *available at* https://comptroller.texas.gov/taxes/audit/docs/contractor-manual.pdf.

for new construction, the contractor should have paid tax on the materials at the time of purchase and not charged the property owner any tax. The auditor will issue an assessment to the contractor for Texas sales and use tax due on his materials purchases because he improperly claimed the sale for resale exemption. The contractor may not use the tax that the property owner paid on the materials to offset his audit liability because, generally, only the person who paid the tax collected in error is entitled to the refund.[48]

c. Failure to Modify Standard Contracts

Many contractors use standardized industry contracts and billing forms, such as those promulgated by the American Institute of Architects, to govern their work. However, these documents are generally drafted for nationwide use and, thus, contractors should modify the sales and use tax provisions to properly document the Texas tax consequences of a given project. One contract size certainly does not fit all when it comes to Texas sales and use tax.

i. Tax-Included Contracts

Texas sales and use tax is a debt of the purchaser of taxable items.[49] The seller or service provider is responsible for collecting the tax from the purchaser and remitting it to the Texas Comptroller.[50] However, the Texas sales and use tax laws allow the Comptroller to pursue either the purchaser or the seller for unpaid tax.[51] Therefore, as relevant to the construction industry, the Comptroller may pursue either the general contractor or his subcontractors for any tax due on the transactions between them.

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[48] *Id.*

[49] 34 TEX. ADMIN. CODE § 3.286(d)(2)(A) (2018).

[50] 34 TEX. ADMIN. CODE § 3.286(d)(1)(A), (B) (2018).

[51] *See* 34 TEX. ADMIN. CODE § 3.286(d)(2)(A) (2018).

To shift the sales tax liability solely to the seller, the parties' contract must include a properly drafted tax-included provision. Per Comptroller rule, the contract must state "the stated price includes sales or use tax."[52] This provision means that the agreed price includes the sales and use tax as one of its components, even though the tax is not separately-stated. Comptroller decisions have stressed that, unless the taxpayer produces a written, controlling document with proper tax-included language, the presumption is that tax is not included in the sales price.[53] Contracts, bills or invoices stating that "all taxes" are included are not sufficiently specific to relieve either party to the transaction of sales and use tax responsibilities.

Parties must use the language recited above to create a tax-included contract, as illustrated by *Perry Homes v. Strayhorn*.[54] In *Perry Homes*, a residential home builder contracted to purchase taxable services in connection with its construction of new residential real estate.[55] The Comptroller assessed tax on the builder's purchases of subcontracting services.[56] The builder argued that its contracts with its subcontractors included sales tax in the contract price, pointing to contract language stating that its subcontractors would indemnify the builder for any taxes due, including sales tax.[57] The builder also offered evidence of letters that it wrote to its subcontractors,

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[52] 34 TEX. ADMIN. CODE § 3.286(d)(2)(B) (2018).

[53] Comptroller Hearing No. 40,433 (STAR No. 200508322H) (Aug. 26, 2005); Comptroller Hearing No. 44,143 (STAR No. 200407830H) (July 16, 2004); Comptroller Hearing No. 37,948 (STAR No. 200209562H) (Sept. 25, 2002).

[54] 108 S.W.3d 444 (Tex. App.—Austin 2003, no pet.).

[55] *Id*. at 445.

[56] *Id*.

[57] *Id*.

confirming that their fees satisfied all tax obligations.[58] The Third Court of Appeals held that the builder's subcontracts were not tax-included contracts because they did specify that "the stated price includes sales tax."[59] To the contrary, the contracts and the letters to the subcontractors merely sought to indemnify the builder from any tax due and did not shift the liability solely to the seller.[60] As *Perry Holmes* illustrates, private parties may not simply contract away Texas sales and use tax obligations.

It is important for contractors to understand when use of a tax-included contract provision is necessary. For example, a contractor who issues a bid that includes Texas sales and use tax should include a tax-included provision in the contract for that project. Otherwise, the Comptroller may assess the difference between the tax that the contractor backed out and the tax due on the entire contract price. More specifically, if the contractor uses a lump-sum contract for a $100,000 commercial repair and remodeling job, the tax due, absent tax-included language is $8,250. But if the contractor treated the contract as tax-included even though the contract lacked the necessary language, he would have remitted only $7,621 in tax. The Comptroller may assess the contractor for the $629 difference in tax, plus penalty and interest. These small underpayments add up across all jobs in the typical four-year audit period.

ii. Incorporation of Documents that Impact Contract Pricing

Contractors must be aware of the Texas sales and use tax ramifications of incorporating documents—like payment applications or invoices—by reference into their construction contracts because it may adversely impact the intended contract pricing structure. For example,

[58] *Id*. at 446.

[59] *Id*.

[60] *Id*. at 446-47.

incorporating by reference the terms of a prime contract may affect whether a subcontract is classified as lump-sum or separated.[61] Similarly, a lump-sum contract that requires the use of separate invoices or incorporates by reference a schedule of values that separately states the charges for labor and materials may convert the contract into a separated one.[62]

Converting the intended pricing structure of a construction contract can lead to audit issues. For example, a contractor who intends to perform new construction on a lump-sum basis but whose contract incorporates schedules of value separately stating the charges for labor and materials is at risk of an auditor reclassifying the contract as separated and creating an assessment of tax on the contractor's material charges. And, while the reclassification would mean that the contractor is entitled to a credit for tax paid in error to his vendors on materials purchases, the credit will not wipe out the higher tax assessment if he imposed a markup on the materials that is subject to tax. Therefore, contractors should include language in their contracts expressly stating that the parties do not intend for any incorporated documents to change the contract pricing structure for Texas sales and use tax purposes.

V. **Conclusion**

The Texas sales and use tax laws applicable to the construction industry are tricky, and auditors know that they can easily generate assessments against contractors. Therefore, contractors must have a firm grasp of the laws if they hope to minimize the chance of a substantial audit assessment and to preserve their profit margins.

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[61] 34 TEX. ADMIN. CODE § 3.291(a)(8) (2002).

[62] Comptroller Hearing No. 40,445 (STAR No. 200205246H) (May 30, 2002).

Appendix A

Texas Comptroller of Public Accounts STAR System

201808031L

Tax Policy News
August 2018
Sales Tax

Sales Tax

Contractors and Related Services

Part 1 - The Sales Tax ABCs for Contractors and Taxable Service Provider s

In this month’s issue, we introduce the first part of a four-part guide about contractors, taxable service providers and related services. Part 1 covers terminology and the taxability of real property improvements in Texas, and provides basic principles for determining the taxability of new construction and real property repair, remodeling and restoration.

Who are Contractors and Taxable Service Providers?

If you perform new construction; residential real property repair, remodeling, maintenance, restoration; or nonresidential real property scheduled and periodic maintenance, you are a contractor.

If you repair, remodel or restore nonresidential real property, you are a taxable service provider.

Am I Making a Real Property Improvement or Installing Tangible Personal Property?

The first step in understanding your tax responsibility is to determine whether an item is incorporated into the real property, a real property improvement, or remains tangible personal property (TPP) after you install it.

To determine if an item is incorporated into the real property, you must consider the following questions:

1. Is the item annexed (or connected) to the real property?
2. Is the item fitted or adapted to the real property?
3. Was the item intended to become a permanent part of the real property?

Note that the third question is considered the most important, with the first two being evidence to support it. Generally, if you would damage the real property, the item or both when removing the item after installation, the item has been incorporated into the real property.

If, in light of the three questions, the item is incorporated into the real property, then you are providing a real property improvement and are considered either a contractor or taxable service provider.

For example, creating a retaining wall is a real property improvement because the materials used in building the retaining wall are intended to remain in the wall permanently.

Examples of real property improvements include:

- toilets
- sinks
- faucets
- garage door openers
- kitchen cabinets
- building materials (such as wood, brick, concrete)
- ceiling fans
- flooring
- hardscaping (such as retaining walls, ponds, sprinkler systems, etc.)

If you are not incorporating TPP into the real property, then you are delivering or installing TPP and must collect sales and use tax on the total price (including installation labor, materials and all related charges) for the TPP.

For example, attaching a television to a wall mount in a residence is installing TPP because the television is not intended to be a permanent part of the real property. The owner is likely to remove the television and take it with them when selling the home.

Other examples of installing TPP are freestanding appliances (refrigerators, dishwashers, clothes washers and dryers), televisions, telephones and computers.

What Type of Property Am I Working On?

Once you have determined that you incorporate TPP into real property, you must determine what type of property the work is being performed on: residential or nonresidential.

Residential Property

Residential property is a building used as a residence, not as a business. Property next to and connected to those buildings is also residential property.

Residential property includes family homes, multifamily apartments or housing complexes (including homeowner and tenant common areas), condominiums, nursing homes and retirement homes.

Nonresidential Property

Nonresidential (commercial) property is property without facilities for people to live in. It includes buildings and other improvements built into, or affixed to, the land such as office buildings, shopping centers, industrial parks, bridges, hotels, motels, etc.

What Type of Contract Can I Use?

You must take into consideration the type of contract you use to determine your tax responsibilities. You can use either a lump-sum contract or a separated contract. Your tax responsibilities are different for each one.

Lump-Sum Contracts

Lump-sum contracts are also known as “one-fixed-price” or “turn-key” contracts. You bill your customer one amount for both labor and incorporated materials instead of separately stating them. Separated amounts on invoices issued to the customer will not change a lump-sum contract into a separated contract unless the terms of the contract require separated invoices.

Separated Contracts

Separated contracts are also known as “time and materials” contracts. You bill your customer by separately stating labor and incorporated material charges. As long as you state the charges for the incorporated materials and labor separately, it does not matter if the charges are added together and the total is provided. Cost-plus contracts are considered separated contracts if the cost of labor is separately stated from the cost for incorporated materials.

Your contract with your customer has priority over any bids or invoices you provide them. For example, if you have a lump-sum contract to perform residential repair work for your customer, separated bids or invoices will not change it to a separated contract. If there is no written contract, then the written bid determines the tax responsibilities. If there is no written contract or bid, then the written invoice determines tax responsibilities.

What are Incorporated Materials, Consumables and Equipment?

As a contractor or taxable service provider, you use incorporated materials, consumables, and equipment to complete your construction projects. Knowing how to classify the items you use will help you understand if you must pay sales tax.

Incorporated Materials

Incorporated materials are items that are incorporated into, and become a part of, any permanent real property improvement such as construction items (brick, drywall, mortar, lumber), central air conditioning units, lighting fixtures, electrical receptacles, flooring (tile, wood, carpet), paint and shingles.

Consumables

Consumables are non-reusable, single-use (nondurable) items used for construction projects such as non-reusable drop cloths, disposable latex gloves, barricade tape, electricity, natural gas, chalk or non-reusable concrete forms.

The following are not consumables: machinery, equipment, incorporated materials, durable items, office supplies or rented (or leased) items.

Equipment

Equipment is any item you use that is not an incorporated material or a consumable item. Equipment includes tools (screwdrivers, hammers), machinery (lathes, saws, drills) and accessories, or repair or replacement parts

for machinery.

What Type of Work Do I Perform?

The type of work you perform for your customer is a primary factor in determining your sales tax responsibilities. You can perform new construction, repair, remodeling, restoration or maintenance work on residential or nonresidential real property.

New Construction

New construction means building all new improvements to either residential or nonresidential property, and includes adding new usable square footage to a property or performing the initial finish-out of an existing building before its initial occupancy or use.

The initial finish-out refers to completion of the interior or exterior of an unfinished residential or nonresidential real property improvement so that it meets an owner's or lessor's requirements.

Some new construction examples are:

- constructing a new shopping mall
- building a new home
- building a new school
- performing the initial finish-out of a space (such as installing fixtures, drywall, cabinets, etc.) that has never been occupied in a strip mall
- adding new square footage (such as a new room) to an existing home or building
- installing a new sprinkler system in a lawn
- paving a new parking lot
- constructing a new commercial building
- building a new playground
- expanding an existing one-story building from 2,000 square feet to 3,000 square feet
- adding stories to an existing building
- completely demolishing an existing residential or commercial building down to the slab and constructing a new building in its place

Hardscaping is a real property improvement and the first installation of hardscaping (such as retaining walls, ponds, lawn sprinkler systems, etc.) is new construction.

Repairing, Remodeling or Restoring Property

Repairing property means mending or bringing the broken, damaged or defective real property back as near as possible to its original working order.

Remodeling or restoring property means rebuilding, replacing, altering, modifying or upgrading the existing real property.

Some examples of repairing, remodeling and restoration work are:

- partial demolition work
- any work done after the finish-out of an existing residential or commercial building
- fixing a leaking faucet
- fixing a fence
- unclogging a toilet
- remodeling a bathroom, kitchen or office
- replacing a roof
- replacing carpet or flooring
- replacing a central air conditioning unit
- replacing part of an existing parking lot
- repairing an existing retaining wall

Tax Responsibilities

Each of the following scenarios provides a summary from the contractor's or service provider's point of view and explains their tax responsibilities.

New Construction

The labor for new construction is not taxable. The incorporated materials are taxable. The person or entity responsible for paying the tax depends on the type of contract used.

As a contractor, you can bill your customers using either a lump-sum or a separated contract. Your tax responsibilities are different for each one. If your customer provides the materials, then you are providing labor only. You're not responsible for tax on the materials.

Lump-Sum Contracts

Under a lump-sum contract, you do not collect sales tax on materials or labor from your customer. You are the consumer of all items purchased to perform the work. You are not a seller.

Under a lump-sum contract, you must:

- pay sales or use tax on consumable supplies, tools and equipment used to do the work;
- pay sales or use tax to your suppliers on the incorporated materials at the time of purchase; and
- accrue and pay tax on materials bought tax free, either removed from your inventory or bought outside of Texas.

For items bought tax free, you must accrue state and local use tax based on:

- the jobsite location if the items are delivered directly to the jobsite from outside Texas; or
- the location where the items are first stored.

Use our Sales Tax Rate Locator to search for sales tax rates by address. In addition, for exempt contracts tax may not be due on incorporated materials, consumables and certain taxable services. See the "Contracts with

Exempt Organizations" section in this article.

Separated Contracts

Under a separated contract, you are the seller of the incorporated materials. You must collect tax on the incorporated materials billed to your customer, but there is no tax due on labor.

Under a separated contract, you must:

- pay tax on consumable supplies, tools and equipment used to do the work;
- give Form 01-339, Texas Sales and Use Tax Resale Certificate(PDF), to sellers instead of tax when buying:
    - incorporated materials and
    - subcontracted taxable services resold to the customer to complete the job; and
- collect from your customer:
    - tax on the incorporated materials;
    - Form 01-339 (back), Texas Sales and Use Tax Exemption Certificate(PDF), instead of sales tax on the incorporated materials, if an exemption applies; or
    - Form 01-339, Texas Sales and Use Tax Resale Certificate(PDF), on the incorporated materials, if you are performing a subcontract for a general contractor who is working under a separated contract.

You will collect local sales taxes based on the tax rate at the jobsite location. Use our Sales Tax Rate Locator to search for sales tax rates by address. In addition, for exempt contracts, tax might not be due on incorporated materials, consumables and certain taxable services. See the "Contracts with Exempt Organizations" section in this article.

Tax-Free Inventories

If you perform both lump-sum and separated contracts, and do not know at the time of purchase which type of contract you will use the incorporated materials under, you may purchase the materials tax-free for resale by issuing Form 01-339, Texas Sales and Use Tax Resale Certificate(PDF) and placing them in a tax-free inventory. You then must:

- charge sales tax on them, or accept a resale certificate if you subcontract to a general contractor working under a separated contract, if you are working under a separated contract; or
- accrue use tax on them when you remove them from inventory to perform a lump-sum contract.

Local taxes are due based on the jobsite if you remove the items to perform the work under a separated contract. Local taxes are due based on the location where your inventory is stored if you remove the materials to perform work under a lump-sum contract.

Residential Repair, Remodeling, Restoration and Maintenance

Labor to repair, remodel, restore or maintain residential real property is not taxable. Materials incorporated into the real property are taxable. The individual or entity responsible for paying the tax depends on the type

of contract used. The taxing responsibilities for residential repair, remodeling and restoration are identical to those for new construction. See the “New Construction” section in this article.

Nonresidential Repair, Remodeling and Restoration

When you repair, remodel or restore nonresidential real property, you are a taxable service provider. Any restoration, repair or remodeling work done after the initial finish-out of an existing nonresidential (commercial) building is taxable.

The total charge for both labor and materials used to repair, remodel or restore nonresidential real property is taxable. It makes no difference whether you use a lump-sum or separated contract to bill your customer.

If your customer provides the incorporated materials, then you are providing labor only, which is taxable. You are not responsible for the tax on incorporated materials, your customer is.

Tax is due on the entire charge to your customer, and you must:

- pay tax on consumable supplies, tools and equipment used to do the work;
- give Form 01-339, Texas Sales and Use Tax Resale Certificate(PDF), to vendors when buying incorporated materials and subcontracted taxable services resold to the customer; and
- collect from your customer:
    - tax on the total charge;
    - Form 01-339, Texas Sales and Use Tax Resale Certificate(PDF), if you are performing a subcontract for another service provider; or
    - Form 01-339 (back), Texas Sales and Use Tax Exemption Certificate(PDF), instead of sales tax if an exemption applies.

The tax you collect is based on the tax rate at the jobsite location. Use our Sales Tax Rate Locator to search for sales tax rates by address. In addition, for exempt contracts, tax may not be due on incorporated materials, consumables, and certain services. See the “Contracts with Exempt Organizations” section below.

Contracts With Exempt Organizations

An exempt organization is an entity that is either exempt under state or federal law or approved by our office to be exempt from Texas sales and use tax. Be aware, though, that some exemptions only apply to specific types of exempt entities.

Federal, state and local governments are automatically exempt from Texas taxes.

Many non-profit organizations have been granted Section 501(c) exemption status by the Internal Revenue Service (IRS), which is a federal entity. This Section 501(c) status does not automatically grant the organization tax exemption in Texas.

To be recognized as exempt from Texas sales and use tax, these organizations must apply to the Comptroller’s office for exemption on purchases necessary for an organization’s exempt purpose. You can verify an organization’s exempt status using our Texas Tax-Exempt Entity Search.

Be aware that certain exemptions are available for projects performed for certain Section 501(c) and other nongovernmental exempt organizations. The work you perform, though, must be related to the exempt

organization's primary purpose. If the job is unrelated to that purpose, then the associated exemptions are invalid.

When you do work for an exempt organization, you must get proof showing the contract is exempt. For a qualifying nongovernmental exempt organization, this is a Form 01-339 (back), Texas Sales and Use Tax Exemption Certificate(PDF). For a governmental entity, a written contract or purchase order is also acceptable documentation.

When your contract is with an exempt organization, and you have received proof of exemption from the entity, you can give your suppliers your own exemption certificate referencing the exempt contract and listing yourself as the purchaser instead of paying sales tax on:

- incorporated materials;
- consumables that are essential to the job and completely used up or destroyed after one use at the job site; and
- taxable services performed at the job site that are integral to completing the job and specifically required by the contract.

For example, a city hires you to repair a city road. You can give an exemption certificate instead of paying tax for taxable items incorporated into the road (such as concrete, asphalt, etc.) and on certain types of consumable items you use to complete the job (such as barricade tape).

If your customer provides the materials, then you are providing labor only. You are not responsible for the tax on the materials.

You must pay tax on items you use to provide your services such as machinery, equipment, accessories or repair and replacement parts for your equipment and machinery used at the job site, office supplies, furniture and computers.

Note, your machinery and equipment are specifically excluded from the exemption discussed above. For example, if you need to rent a backhoe to complete the road job, you owe tax on the backhoe rental. This is true even if the exempt entity reimburses you for the tax.

Conclusion

In conclusion, to properly apply and collect or pay the appropriate taxes, contractors and services providers should analyze their transaction by answering five key questions:

1. Am I installing tangible personal property or improving real property?
2. What type of property am I working on?
3. What type of work am I performing?
4. What type of contract do I have with my customer?
5. Is my customer exempt from sales and use taxes?

ACCESSION NUMBER: 201808031L
SUPERSEDED: N
DOCUMENT TYPE: L
DATE: 2018-08-01

TAX TYPE: SALES

Appendix B

201809024L

Tax Policy News
September 2018
Sales Tax

Sales and Use Tax

Contractors and Related Services

In this month's issue, we continue our series (Part 1 @ 201808031L) that takes a close look at the sales tax treatment for specific contractors, repairmen and other service providers.

Part 2 - Breaking Down Demolition Services

Demolition involves tearing down buildings and other man-made structures by implosion or using non-explosive methods such as a wrecking ball.

The complete demolition of a real property improvement (such as a building or parking lot) is not taxable. Any partial demolition is considered real property remodeling and the taxability depends on whether the work performed is on residential or nonresidential property.

Complete demolition of a real property improvement means to destroy the improvement down to the slab or bare ground. Total demolition of a building means the entire structure is removed except for the slab. Note that parking lots are separate real property improvements from buildings.

For example, the complete demolition of a parking lot means to demolish the lot down to the dirt. Retaining any portion of the previous real property improvement such as a sidewall, steel columns or joists, or a section of the parking lot, etc., is partial demolition and considered remodeling.

If a company only performs complete demolition services, it is not required to have a sales tax permit or collect tax on this nontaxable service. If, however, the company performs partial demolition or other services (such as debris removal, new construction or remodeling services, etc.), then it may be required to have a sales tax permit and collect tax.

A provider of a demolition service owes tax on all materials and equipment bought, leased or rented to provide the service.

Waste Removal (Real Property Services)

Waste removal services are taxable real property services. Real property service providers must collect tax on their services and pay tax on all materials and equipment bought, leased or rented for use in providing the waste removal services.

If a company bills its customer separately stated charges for both complete demolition and waste removal services, it only collects tax on the taxable waste removal services.

For example, a company charges its customer $40,000 for its services: $27,000 for complete demolition and $13,000 for debris removal services. The assumed sales tax rate is 8.25 percent.

Separated Contract

Item	Amount
Complete Demolition	$ 27,000
Waste Removal	$ 13,000
State and Local Sales Tax (8.25% x $13,000)	$ 1,072.50
Total	$ 41,072.50

If the company bills its customer a lump-sum charge for both the complete demolition and waste removal services, and the waste removal charges are more than 5 percent of the entire bill, then it must collect tax on the entire charge to its customer.

Using the same charges from the previous example:

Lump-Sum Contract

Item	Amount
Complete Demolition and Waste Removal	$ 40,000*
State and Local Sales Tax (8.25% x $40,000)	$ 3,300
Total	$ 43,300

*A single charge for complete demolition and waste removal services, when the waste removal services are more than 5 percent of the single charge, is taxable. If the service provider separately states the charges, they only need to collect tax on the taxable waste removal services.

Real Property Improvements After Demolition Services

Complete Demolition

Making new real property improvements following complete demolition services is new construction. A company performing new construction is considered a contractor.

For example, if a company destroys an entire parking lot down to the dirt, the new parking lot it builds is new construction. Likewise, for the construction of a building on an existing site to qualify as new construction, a company would need to demolish the existing building to its slab or foundation, with no remaining walls or ceilings above the ground floor slab or foundation.

For new construction, the construction labor and demolition services are not taxable, but the incorporated materials and waste removal services are taxable. The party responsible for paying the tax on the incorporated materials and the waste removal services depends on the type of contract used.

Contractors performing new construction contracts under a lump-sum contract (a lump-sum amount that does not separate the charges for incorporated materials or labor) are consumers of all materials, consumable items and equipment used or incorporated into a customer's property.

As a consumer, a lump-sum contractor must pay tax to suppliers when buying the materials. If the materials are purchased from an out-of-state seller, a contractor must accrue and remit use tax on the materials, unless Texas use tax was collected by the out-of-state seller. A contractor must not collect tax from a customer on a lump-sum charge or on any portion of the charge.

Contractors performing separated contracts (the charges for incorporated materials and labor are separately stated) are the retailers of all materials physically incorporated into the real property improvement. As a retailer, a contractor may issue a resale certificate and must collect tax from the customer based on the agreed contract price of the incorporated materials and other taxable services provided.

Here are some examples of how the type of contract affects tax collection and payment responsibilities. In these examples, a company charges its customer $340,000 for its services: $27,000 for the complete demolition, $13,000 for waste removal and $300,000 for the new construction. The assumed sales tax rate is 8.25 percent.

Lump-Sum Contract

Item	Amount
Complete Demolition, Waste Removal, and New Construction	$ 340,000**
State and Local Sales Tax (8.25% x $340,000)	$ 28,050
Total	$ 368,050

**Again, because the waste removal service exceeds 5 percent of the single charge (i.e., is not separately stated), the entire service is presumed to be for taxable waste removal services. However, the service provider may separate the charges under Rule 3.356(i)(2) and charge tax only on the $13,000 charge for waste removal services.

Separated Contract

Item	Amount
Complete Demolition	$ 27,000
New Construction (Incorporated Materials)	$ 110,000
New Construction (Labor)	$ 190,000
Waste Removal	$ 13,000
State and Local Sales Tax (8.25% x $123,000)***	$ 10,147.50
Total	$350,147.50

***$110,000 for incorporated materials + $13,000 for waste removal

Partial Demolition

Partial demolition of existing realty and any real property improvements made following partial demolition services is remodeling. The taxability of remodeling depends on the type of property (residential or nonresidential).

If you perform residential remodeling, you are a contractor. For residential remodeling, the remodeling labor and demolition services are not taxable, but the incorporated materials and waste removal services are taxable. The party responsible for paying the tax on the incorporated materials and waste removal services depends on the type of contract used.

If you perform nonresidential remodeling, you are a taxable service provider. For nonresidential remodeling, the taxable service provider must collect tax on the total charge (including the demolition services). It makes no difference what type of contract is used.

Looking Ahead

In the next part of our series, we will revisit topics from a previous Tax Policy News article, “Caught in the Middle - Contracts With Exempt Entities: Purchases of Taxable Services, Supplies and Rental Equipment by the ‘Middleman.’”

More Information

- Rule 3.291 - Contractors
- Rule 3.356 - Real Property Service
- Rule 3.357 - Nonresidential Real Property Repair, Remodeling, and Restoration; Real Property Maintenance

Qualifying Exempt Organizations and Real Property Improvements: Understanding When Incorporated Materials Can Be Purchased Tax Free

This article will provide guidance on the exemption for incorporated materials used in performing real property improvements for a governmental entity or qualified religious, educational and public service nonprofit organization.

Buying Incorporated Materials

Certain incorporated materials can be purchased tax free when performing a real property improvement for governmental entities (under Section 151.309) or qualifying religious, educational and public service nonprofit organizations (under Section 151.310). This exemption applies even when the contract is between a nonexempt entity (such as a subcontractor) and a contractor if the contract is an "exempt contract."

An exempt contract is a contract to improve real property for an exempt organization's primary use and benefit as long as the improvements relate to the organization's purpose. When the job's primary use and benefit does not fulfill the exempt entity's primary purpose, the exemption is lost.

Exempt Example

A Texas public university, which is an exempt governmental entity, decides to lease property to a for-profit entity to build a dormitory for its students. The for-profit entity will purchase the construction materials under a construction contract with a contractor. The university will have control over the dormitory. Because the dormitory enhances the university's educational operations, the dormitory fulfills the university's exempt purpose. The for-profit entity may issue a properly completed exemption certificate to the contractor building the dormitory. The contractor can then provide an exemption certificate to their vendor instead of paying sales tax on the incorporated materials, qualifying consumables and qualifying taxable services.

Taxable Example

A Texas private university that qualifies as an exempt organization decides to lease property to a for-profit entity to build retail space to lease to other businesses. The for-profit entity will purchase the construction materials under a construction contract with a contractor. The private university will have limited control over the property for the duration of the lease. The for-profit entity allows any patrons to shop at the retail space, and the businesses are able to use the retail space for their own general business needs such as rental revenue or selling items or services. Because the university will not primarily benefit from the retail space's operation, the retail space is not for the primary use and benefit of the private university. The for-profit entity cannot give an exemption certificate to the contractor.

Leases

An exempt organization is not required to own the real property improvement, and the exemption can apply when the exempt organization leases the real property. If a taxable entity owns an improvement, such as a building, which is leased to an exempt entity, the exemption applies if the life of the lease equals or exceeds the expected useful life of the real property improvement.

If the life of the lease is less than the expected useful life of the real property improvement, then the exemption does not apply. If a lease between the owner and the exempt entity is for a specific period and the exempt entity has the option, but is not contractually obligated to renew the lease, the option is not considered when determining if the exemption applies.

For example, a Texas tax-exempt educational organization decides to lease an entire campus from a nonexempt entity. Under the lease, the property owner (lessor) acquires a site, constructs new facilities and

leases the campus for 25 years. The planned improvements have an expected useful life of 22 years.

Because the lease is greater than the real property improvement's expected useful life, the contract is making a real property improvement for the exempt entity and qualifies as an exempt contract. The educational organization can issue a properly completed exemption certificate to the contractor building the campus. The contractor can then provide an exemption certificate (PDF) to their vendor instead of paying sales tax on the incorporated materials, qualifying consumables and qualifying taxable services.

More Information

- STAR Accession No. 200910694H
- STAR Accession No. 200310283H
- STAR Accession No. 201405903L
- STAR Accession No. 200108598L
- Texas Tax Code Section 151.309 – Governmental Entities
- Texas Tax Code Section 151.310 – Religious, Educational, and Public Service Organizations
- Texas Tax Code Section 151.311 – Taxable Items Incorporated Into or Used for Improvement of Realty of an Exempt Entity
- Rule 3.291 – Contractors

ACCESSION NUMBER: 201809024L
SUPERSEDED: N
DOCUMENT TYPE: L
DATE: 2018-09-03
TAX TYPE: SALES

Appendix C

201810029L

Tax Policy News
October 2018
Sales Tax

Sales Tax

Contractors and Related Services

Part 3: "Caught in the Middle"- Revisited *(Note: the issues in this article were previously addressed in STAR 200904585L.)*

In this month's issue, we are continuing with our contractor series and looking at agency agreements.

In our August Tax Policy News article, "The Sales Tax ABCs for Contractors and Taxable Service Providers," *(STAR 201808031L)* we discussed the applicability and responsibility for sales and use taxes on taxable items bought, leased or rented to complete projects for exempt organizations. In summary, a contractor can buy incorporated materials, consumables and certain qualifying taxable services tax free for an exempt contract.

The contractor, however, must pay tax on equipment used in completing their work. They cannot give the seller a resale or exemption certificate for equipment they use in their work because they are the end user of the equipment.

The equipment is not re-rented to the exempt organization, and the exempt organization's exempt status does not flow through to the contractor. The contractor can, however, ask for an equipment and tax reimbursement from the exempt entity. The exempt entity is simply paying an expense (including the tax paid by the contractor) for a cost incurred in completing the contract. The exempt entity is not paying sales tax to the contractor on a purchase for the entity's use that the entity could claim as an exempt purchase.

Agency Agreements

An exempt organization can enter into an agency agreement with a contractor. This agreement authorizes the contractor to buy items and services tax free on the exempt organization's behalf.

Three elements are necessary to demonstrate that an agency relationship exists:

- one person (the agent) is acting for another (the principal);
- both parties consent to the arrangement; and
- the agent is under the principal's control.

Although an agency agreement might be implied from the parties' conduct, and it might be determined that one exists based on that conduct alone, Comptroller authorities require a written agreement to confirm such a relationship. That is, a written agreement is the only way to verify an agency agreement.

Note: agency agreements apply only to materials incorporated into the job.

Documentation Requirements

When buying items or services on the exempt organization's behalf, the contractor must disclose that they are acting as the exempt organization's agent. The contractor can give a properly completed exemption certificate (PDF) to the seller for taxable items.

When acting as an agent, the contractor cannot mark up the item's purchase price. Charges to the exempt organization must show the actual amount paid to suppliers. Any charges identified as a collection of tax, however, must be remitted to the Comptroller's office.

The contractor must maintain accounting records and invoices proving that the charges to their clients are identical to what was paid.

Refunds

If the contractor pays sales tax in error, they are due a refund and can:

- take a credit in the amount of the refund on a future sales tax return;
- amend the return to take a credit in the amount of the refund for the period in which the sales tax was paid; or
- request a refund from the Comptroller's office.

For more information, see Sales Tax Refunds.

More Information

- Rule 3.281 – Records Required; Information Required
- Rule 3.291 – Contractors
- Rule 3.325 – Refunds and Payments Under Protest
- STAR documents 201604754L, 8910L0965E11, 200405686H, 201103048H and 200904585L

ACCESSION NUMBER: 201810029L
SUPERSEDED: N

DOCUMENT TYPE: L
DATE: 2018-10-01
TAX TYPE: SALES

Appendix D

Texas Comptroller of Public Accounts STAR System

201812016L

Tax Policy News
December 2018
Sales Tax

Sales Tax

Contractors and Related Services

Part 4 – Pipe Works: Understanding New Construction vs. Repair, Remodeling and Restoration for Pipelines

In this month's issue, we are concluding the contractor series with a look at the tax treatment for pipeline construction. This article summarizes the tax treatment of new construction work and real property repair, remodeling and restoration work and examines the tax application to pipeline construction work.

Contractors perform new construction. Taxable service providers perform nonresidential real property repair, remodeling and restoration.

When performing pipeline construction work, tax responsibilities depend on the type of:

- work being done (new construction, repair, remodeling, restoring or maintenance); and
- contract being used (lump-sum or separated).

As previously discussed in the August Tax Policy News article (STAR 201808031L), The Sales Tax ABCs for Contractors and Taxable Service Providers, in a lump sum contract you charge one amount for both labor and incorporated materials. In a separated contract, you separately state your labor and materials.

See Rule 3.291, Contractors, and Rule 3.357, Nonresidential Real Property Repair, Remodeling, and Restoration.

New Construction

A contract to build an addition to an existing nonresidential structure or to build a new structure is a real property improvement and taxed as “new construction.” The person making the improvements is a contractor. Note that the labor to “tie in” a new to an existing structure is taxable remodeling labor (see information below on repair, remodeling and restoration work). If this labor is included in the new construction contract and the charge for remodeling is less than 5 percent of the total job, it can be excluded from tax. If the charge is 5 percent or more, the charge for remodeling must be separately stated and taxed or the total contract will be subject to tax.

Contractors performing new construction under lump-sum contracts are consumers of all materials, consumable items and equipment used or incorporated into customers’ properties. As consumers, contractors must pay tax to suppliers when buying the materials. If the materials are purchased from out-of-state sellers, contractors must accrue and remit use tax on the materials, unless Texas use tax was collected by the out-of-state sellers. Contractors do not collect tax from customers on lump-sum charges or on any portion of the charges.

Contractors performing separated contracts are the retailers of all materials physically incorporated into the real property improvements. As retailers, contractors collect tax from customers based on the agreed contract price of the incorporated materials.

Repair, Remodeling and Restoration Work

Nonresidential repair, remodeling and restoration services are taxable. A person repairing, remodeling or restoring nonresidential real property is a taxable service provider, rather than a contractor.

All taxable service providers who repair, restore or remodel nonresidential real property either collect tax on the total sales price to their customers, or accept a valid Form 01-339 (front), Texas Sales and Use Tax Resale Certificate(PDF); Form 01-339 (back), Texas Sales and Use Tax Exemption Certificate(PDF); or Form 01-919, Texas Direct Payment Exemption Certification Limited Sales, Excise and Use Tax Certificate(PDF), instead of tax. When the work is for nonresidential real property repair, remodeling or restoration, there is no distinction between a lump sum or a separated contract.

Pipeline Construction Work

Last year, in a private letter ruling, the Tax Policy Division outlined the sales tax treatment of different pipeline construction and remodeling services.

For construction services, installing a new pipeline in a new trench is new construction, and the labor is not taxable. The new pipeline’s location in relation to an existing pipeline does not affect the tax treatment.

Additionally, removing an existing pipeline and installing a new pipeline at a lower or greater depth is new construction and the labor is not taxable if the pipeline’s depth changes substantially (the new pipeline’s depth must be at least one-third deeper or shallower than the existing pipeline’s depth). This excavation work to remove the existing pipeline and install the new deeper or shallower pipeline is complete demolition and new construction work, respectively. The labor is not taxable.

In all instances, connecting the new pipeline to an existing pipeline is nonresidential real property repair or remodeling and is taxable. Likewise, replacing the existing pipeline with a new pipeline at the same depth is taxable nonresidential real property repair or remodeling work.

For abandoning the pipeline, filling an existing pipeline with concrete is not taxable because it is complete pipeline demolition. If, however, the service provider caps the ends of an existing pipeline in order to abandon the pipeline in place, the labor is taxable nonresidential real property repair or remodeling.

Services

Unless connected to the sale of a taxable item or service, inspection and testing services are not taxable.

To be nontaxable, stand-alone inspection and testing charges must not be related to any taxable equipment or nonresidential real property repairs, restoration or remodeling.

Mixed Contracts

When nontaxable unrelated services and taxable services are sold or purchased for a single charge and the portion relating to taxable services represents more than 5 percent of the total charge, the total charge is presumed to be taxable. The service provider may later establish the percentage of the total charge that relates to nontaxable services. To do so, the service provider's books must support the apportionment between taxable and nontaxable services.

If a service provider separately states the nontaxable unrelated services from the taxable services, they only charge tax on the taxable services.

More Information

- Rule 3.291 – Contractors
- Rule 3.357 – Nonresidential Real Property Repair, Remodeling, and Restoration; Real Property Maintenance
- State Tax Automated Research (STAR) System letter 201706007L
- Tax Policy Webinar – Mixed Transactions

ACCESSION NUMBER: 201812016L
SUPERSEDED: N
DOCUMENT TYPE: L
DATE: 2018-12-03
TAX TYPE: SALES

Appendix E

Texas Comptroller of Public Accounts STAR System

201911009L

Tax Policy News
November 2019
Sales and Use Tax

Reimbursements for Contractors and Taxable Service Providers

As a contractor or taxable service provider , you may incur some business expenses that you wish to be reimbursed for on a dollar-for-dollar basis (i.e., a reimbursement). A reimbursement is a sum paid to cover money that has been spent or lost. Depending on the contract, type of work, and reimbursement type, you may be required to collect sales tax on your charges.

As a reminder, contractors perform new construction; residential real property repair, remodeling, maintenance, and restoration; or nonresidential real property scheduled and periodic maintenance.

In contrast, taxable service providers repair, remodel, or restore nonresidential real property.

For more information on contractors and taxable service providers, see our August 2018 *Tax Policy News* article, " *The Sales Tax ABCs for Contractors and Taxable Service Providers* ."

What is "Sales Price"?

The sales price is the total cost the customer pays for tangible personal property or a taxable service, including any delivery fees or other expenses included in the cost (such as labor), even if separately stated.

When performing a nontaxable service (such as new construction or residential real property repair, remodeling, and restoration), the related charges (such as inspection charges, permit fee and other reimbursements) are component costs of the service regardless of the contract type (lump-sum total charge or separately stated) with the customer.

Tax Responsibilities

Depending on the contract used, your tax responsibilities as a contractor or service provider will vary.

Contractor – Lump Sum v. Separated

Under a *lump-sum contract* , you are the consumer of all items purchased (or removed from a tax-free inventory) to perform the work. The reimbursement charges incorporated into your lump-sum contract are not taxable, and you do not collect sales tax from your customer on materials, labor, or reimbursements that are part of that charge.

For example, Robert (under a lump-sum contract) completes a kitchen-remodeling project for an existing home in Austin, Texas. He invoices his customer:

- ***Kitchen Remodeling: $45,000***
- Includes:
    - Materials
    - Labor
    - Meal Reimbursements
    - Fuel Reimbursements
- Total Price: $45,000

In this instance, Robert does not need to collect any sales tax from his customer.

Under a *separated contract* , you are the seller of the incorporated materials. You can provide a properly completed resale certificate to your supply vendor instead of paying tax on the incorporated materials and must collect tax on the incorporated materials billed to your customer, but there is no tax due on labor. Reimbursements related to the incorporated materials charge, such as fuel reimbursements for material pickup and delivery, are taxable. Reimbursement charges directly connected to the labor component, such as wait time, per diem, lodging, etc., are not taxable.

Using a similar example, Robert now invoices his customer using a separated contract:

- ***Kitchen Remodeling:***
    - Materials: $25,000*
    - Labor: $19,000
    - Meal Reimbursements: $500
    - Fuel Reimbursement (Material Pick Up): $300*
    - Wait Time: $200
- Subtotal: $45,000
- Sales Tax (8.25 percent): $2,087.25

- Total: $47,087.25

(*) – denotes taxable charges

In this example, Robert must collect sales tax on the taxable portions of the separated contact (i.e., materials and fuel reimbursements). The total sales tax he should collect is $2,087.25, which is ($25,300 x .0825).

Contractor - Reimbursements for Equipment and Consumables

Both lump-sum and separated contractors improving real property must pay tax on equipment purchased or rented to complete the job. Additionally, the contractor owes tax on consumables used at the job site of nonexempt customers at the time of purchase. The contractor should not charge tax to the customer for reimbursement of either of these charges.

A separated contractor may bill the customer for reimbursement of expenses incurred on the purchase or rental of equipment and purchases of consumables used on the job. Sales tax on the purchase or rental of these items is an expense to the separated contractor. The contractor must clearly label these items as a reimbursement.

For example, Robert needs to rent an excavator and purchase various consumables to complete a new irrigation system installation for his nonexempt customer. He invoices his customer:

- ***Irrigation Installation:***
    - Materials: $20,000*
    - Labor: $15,000
    - Consumables Reimbursement: $1,000
    - Equipment Reimbursement: $5,000
- Subtotal: $41,000
- Sales Tax (8.25 percent): $1,650
- Total: $42,650

(*) – denotes taxable charges

In this instance, Robert has indicated the tax-paid consumables and equipment reimbursements on the invoice and does not need to collect tax on these charges. He must still collect tax on the incorporated materials charges ($20,000).

If you do not properly represent the reimbursement of your expenses to purchase or rent equipment or your purchase of the consumables, including the tax you paid, you must remit any charge represented as sales or use tax on your customer's invoice to the Comptroller's office. Documenting these charges as expense reimbursements avoids the customer's perceiving you are collecting taxes.

Reimbursements for Taxable Service Providers

If you repair, remodel, or restore nonresidential real property, you are a taxable service provider . You owe tax when purchasing or renting equipment and consumables you use to complete your projects for nonexempt entities. You are not reselling these items to your customer.

A taxable service provider must collect tax on all charges billed to the customer for the taxable service, regardless of the contract type (lump-sum or separately stated). A service provider must charge tax on a lump-sum charge, including any reimbursements included in that lump-sum charge. For example, Robert renovates an employee breakroom for an existing business office in Houston, Texas. He invoices his customer:

- ***Breakroom Remodeling: $152,000****
- Includes:
    - Materials
    - Labor
    - Meal Reimbursements
    - Fuel Reimbursements
    - Wait Time
- Subtotal: $152,000
- Sales Tax (8.25 percent): $12,540
- Total: $164,540

(*) – denotes taxable charges

Likewise, a taxable service provider must collect tax on all charges made for the service when the charges are separated, including any reimbursement charges. For example, Robert instead invoices his customer using a separated contract:

- ***Breakroom Remodeling:***
    - Materials: $100,000*
    - Labor: $50,000*
    - Meal Reimbursements: $1,000*
    - Fuel Reimbursement (Material Pick Up): $500*
    - Wait Time: $500*
- Subtotal: $152,000
- Sales Tax (8.25 percent): $12,540
- Total: $164,540

(*) – denotes taxable charges

More Information

- Texas Tax Code Section 151.007, "Sales Price" Or "Receipts"
- Rule 3.291, Contractors
- Rule 3.357, Nonresidential Real Property Repair, Remodeling, and Restoration; Real Property Maintenance

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ACCESSION NUMBER: 201911009L
SUPERSEDED: N
DOCUMENT TYPE: L
DATE: 2019-11-01
TAX TYPE: SALES

TO ELECT, OR NOT TO ELECT, S-CORP TAXATION
THAT IS THE QUESTION

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State Bar of Texas Tax Section
Tax Law in a Day
February 7, 2020
Houston, Texas

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The author welcomes any corrections and suggestions for improvements to this outline

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Prior to becoming a lawyer, Jim worked at Bank of America for five years as a participant in the bank's prestigious Technology MBA Leadership Development Rotational Program. During his 5 years at the bank, Jim led a team of over 150 bank employees to implement various technology and organizational improvements. Before his role at Bank of America, Jim worked as a software consultant for five years at a small oil and gas consulting firm in Houston, Texas, where he designed and programmed gas plant accounting software.

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Outside of work, Jim is a legal advisor for the Legacy Foundation at the Ark Church in Conroe, Texas. Additionally, Jim is President of the Montgomery Independent School District school board and President and founding Board Member on the MISD Education Foundation. Jim is also Vice Chair of the Corporate Tax Section of the State Bar of Texas.

Awards and Recognition

- Texas Super Lawyers Rising Star, Thompson Reuters, 2019, 2020
- Tax Leadership Academy, 2017

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TO ELECT, OR NOT TO ELECT, S-CORP TAXATION, THAT IS THE QUESTION

I. INTRODUCTION

Entity taxation has long been an important driver in the selection of entity type for small business owners. Subchapter S of the Internal Revenue Code was originally passed into law in 1958 creating the "S Corporation". On December 22, 2017, the Tax Cuts and Jobs Act ("TCJA") was signed into law by President Donald J. Trump.[1] Among many changes to the tax code, the TCJA introduced two major changes to the tax law that will affect the choice of the election of S Corporation taxation for small businesses:

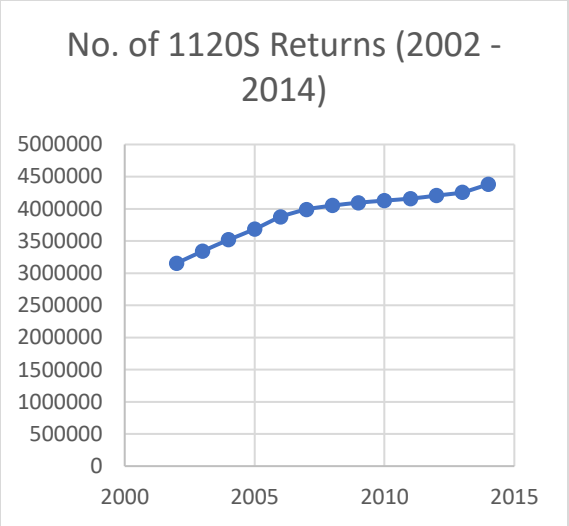
1) the TCJA permanently reduced the corporate tax rate from a maximum of 35% under a graduated tax rate structure to a flat 21%; and

2) the Qualified Business Income Deduction (199A).

The purpose of this paper is to reexamine the S Corporation election for small businesses considering the TCJA.

A. Business Owners Increasingly Elect S Corporation Taxation

IRS statistical data for S Corporations (2014, the last year available) shows that the number of S Corporations has steadily increased to a total of 4,380,125 1120s returns filed in 2014. Most S Corporations are small, averaging 1.65 shareholders and $115,694 net income.



B. The S-Corp Advantage?

1. Avoidance of double tax regime (compared to C corporations)

The primary benefit of S corporation taxation compared to C corporation taxation is the avoidance of the double tax regime. S Corporations are pass-through entities and therefore the earnings are only subject to one layer of taxation at the shareholder level. By comparison, C Corps are first taxed at the entity level (21% after TCJA went into effect). Earnings are again taxed when distributed to shareholders generally at 23.8%[2].

The following tables illustrate the effective tax results for the owners (making many assumptions). Prior to TCJA, the S Corporation tax advantage was much greater than it is today due to the reduction in the corporate tax rate from a maximum rate of 35% to a flat 21%. Now that the corporate tax rate has been reduced, the effect of the double tax regime is almost negligible for high earning taxpayers.

[1] An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97, § 11061 (2017)

[2] IRC §1(h)(11) (20% highest marginal qualified dividend federal income tax rate) and IRC §1411(a) (3.8% Net Investment Income tax rate)

In the example below, prior to the TCJA, $49.53 was left to shareholders in an C Corporation and $56.60 in an S Corporation. After the TCJA, $60.20 remained for shareholders in a C Corporation and $59.20 in an S Corporation.

C Corporation (Prior to 2017 TCJA)

Taxable Income	$100.00
Corporate Rate	35%
Corp Tax Liability	$35.00
Cash Avail to Shareholders	$65.00
Individual Rate	20%
Net Investment Income Rate	3.80%
Individual Tax Liability	$15.47
Total Tax Liability	$50.47
Net to Shareholders	$49.53

C Corporation (After 2017 TCJA)

Taxable Income	$100.00
Corporate Rate	21%
Corp Tax Liability	$21.00
Cash Avail to Shareholders	$79.00
Individual Rate	20%
Net Investment Income Rate	3.80%
Individual Tax Liability	$18.80
Total Tax Liability	$39.80
Net to Shareholders	$60.20

S Corporation (Prior to 2017 TCJA)

Taxable Income	$100.00
Corporate Rate	0%
Corp Tax Liability	$0.00
Cash Avail to Shareholders	$100.00
Individual Rate	39.6%
Net Investment Income Rate	3.80%
Individual Tax Liability	$43.40
Total Tax Liability	$43.40
Net to Shareholders	$56.60

S Corporation (After 2017 TCJA)

Taxable Income	$100.00
Corporate Rate	0%
Corp Tax Liability	$0.00
Cash Avail to Shareholders	$100.00
Individual Rate	37.0%
Net Investment Income Rate	3.80%
Individual Tax Liability	$40.80
Total Tax Liability	$40.80
Net to Shareholders	$59.20

2. Flow-through of Corporate Losses to Owners (compared to C corporations)

A second major reason that owners may prefer to elect S Corporation taxation over C Corporation taxation is the ability to pass losses through to owners of the business, subject to the following:

(a) the ability to pass such losses through to the owners is limited by a) stock and debt basis limitations, b) at risk limitations, and c) passive activity loss limitations; and
(b) the TCJA placed a limitation on the ability of offsetting income with excess business losses if the amount of the loss

is in excess of $250,000 for individual taxpayers ($500,000 for joint returns).[3]

Net losses incurred by C Corporations are deducted from corporate income; they do not pass through to the shareholders.

3. Potential self employment tax reduction (compared to partnerships)

S Corporations may provide a tax advantage over partnerships by reducing self-employment tax. In a partnership, partners are subject to self-employment tax on earnings generated from active involvement in the business. Limited partners in a limited partnership may exclude self-employment tax but general partners are subject to self-employment tax on their distributive share of the income.[4] Courts have generally imposed self-employment tax on all members of limited liability companies unless they lack management authority and don't provide significant services to the business.[5]

With an S Corporation, however, shareholders that actively participate in the business take and pay self-employment tax on a salary. Distributions in excess of the salary are treated as passive income and are not subject to self-employment tax. The salary must be "reasonable" as defined in numerous IRS revenue rules and tax court cases.[6]

The following illustrates a very simplified example of a married couple with earnings of $300,000 and a salary of $100,000. The federal income tax liability is the same for the S Corporation and the partnership, but the S Corporation results in over $10,000 in self-employment tax savings.

S Corporation (After 2017 TCJA)

Earnings	$200,000.00
Salary	$100,000.00
Standard Deduction	$24,800.00
Taxable Income	$275,200.00
Effective Individual Rate	20.0%
Individual Tax Liability	$55,040.00
Self Employment Tax	
Social Security (12.4% to $137,700)	$12,400.00
Medicare tax (2.9%)	$2,900.00
Total Tax Liability	$70,340.00
Net to Owners	$229,660.00

Partnership (After 2017 TCJA)

Earnings	$300,000.00
Salary	$0.00
Standard Deduction	$24,800.00
Taxable Income	$275,200.00
Individual Rate	20.0%
Individual Tax Liability	$55,040.00
Self Employment Tax	
Social Security (12.4% to $137,700)	$17,074.80
Medicare tax (2.9%)	$8,700.00
Total Tax Liability	$80,814.80
Net to Owners	$219,185.20

[3] TCJA amended IRC § 641(I).

[4] IRC § 1402(a)(13).

[5] Proposed Regs. Sec. 1.1402(a)-2.

[6] Guidance from the IRS provided at https://www.irs.gov/businesses/small-businesses-self-employed/paying-yourself

4. Eligibility for the Qualified Business Income Deduction

The TCJA added Section 199A, also known as the Qualified Business Income deduction.[7] Section 199A provides a potential pass-through deduction equal to 20% on allocable "qualified business income".

The relevant portion of 199A[8] is as follows:

> (2) DETERMINATION OF DEDUCTIBLE AMOUNT FOR EACH TRADE OR BUSINESS. The amount determined under this paragraph with respect to any qualified trade or business is the lesser of-
>
> (A) 20 percent of the taxpayer's qualified business income with respect to the qualified trade or business, or
>
> (B) the greater of-
>
> (i) 50 percent of the W-2 wages with respect to the qualified trade or business, or
>
> (ii) 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.

Many articles have been written in detail about Section 199A, so this paper will focus on several important aspects of Section 199A as they relate to the choice of S Corporation taxation:

(a) No C Corporations. Section 199A does not apply to C corporations.

(b) Specified Trades or Businesses. Section 199A does not apply to businesses that are not a "qualified trade or business"[9], which includes doctors, lawyers, accountants, and others. Many of the businesses that would potentially benefit from S Corporation taxation to reduce self-employment tax do not qualify for the 199A deduction. For these types of businesses, the decision to elect S Corporation taxation does not depend on the 199A deduction.

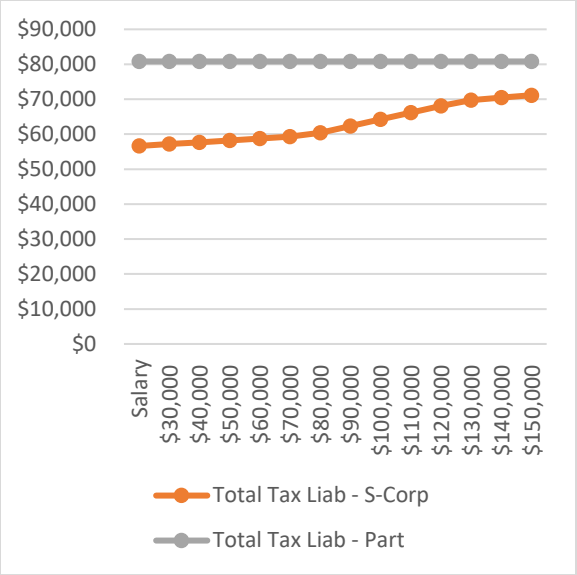
(c) Sole Proprietorships. Sole proprietorships and entities taxed as sole proprietorships such as single member limited liability companies (i.e. disregarded entities) do not have employees and cannot pay the owner W-2 wages. Because they do not pay W-2 wages, the 199A deduction is calculated as $0. By converting to S corporation taxation, the owner may now take a W-2 wage and may have a 199A deduction.

The graph below shows a business owner's total tax liability in a very simplified tax scenario of a married taxpayer with $300,000 in earnings from a sole proprietorship; many assumptions have been made. As can be seen in the graph, the owner's tax liability is reduced significantly if S Corporation taxation is elected compared to partnership taxation.

[7] IRC § 199A.

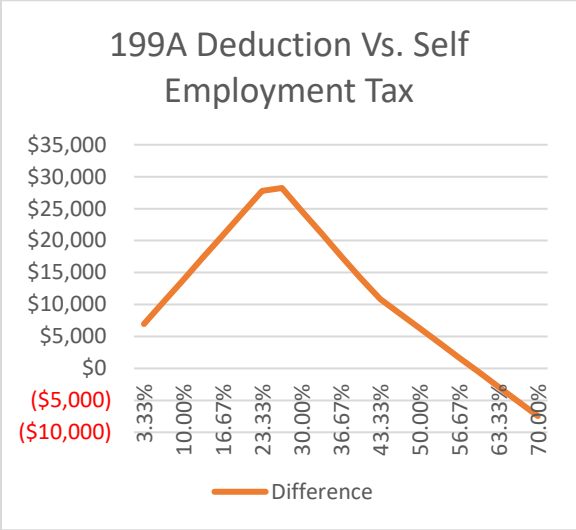
[8] IRC § 199A(b)(2).

[9] IRC § 199A(d).



(d) Tradeoff: 199A Deduction Vs. Self-Employment Tax. To get the greatest reduction in self-employment tax, the business owner is encouraged to reduce his salary to the lowest reasonable salary possible. However, this conflicts with Section 199A, where the deduction amount in part depends on increasing W-2 wages, at least up to the point where 50% of such wages equals 20% of the taxpayer's qualified business income. In other words, the effort to reduce self-employment tax may also reduce the amount of possible 199A tax deduction.

The graph below shows the difference between the 199A deduction and the self-employment tax incurred for a very simplified tax scenario for a married taxpayer with $300,000 in earnings where the business has elected S Corporation taxation and the owner is taking a salary. The x axis represents the ratio of salary to earnings and the y axis represents the difference between the 199A deduction and self-employment tax. As can be seen in the graph, in this scenario the optimal salary vs. earnings percentage is about 27-28%.



I. S-CORP BASICS

A. S-Corporation Defined: 26 US Code Section 1361

Internal Revenue Code Section 1361(a) defines an S Corporation as "a small business corporation for which an election under section 1362(a) is in effect for such year."[10]

Section 1361(b)(1) further defines the term "small business corporation" which does not

(a) have more than 100 shareholders,

(b) have as a shareholder a person who is not an individual, [11]

(c) have a nonresident alien as a shareholder, and[12]

(d) have more than 1 class of stock.

[10] IRC § 1361(a)

[11] LLCs treated as disregarded entities also are eligible shareholders's. See IRS Letter Rulings 9745017, 200107025, 200303032, and 200513001.

[12] TCJA Update: nonresident alien may be a potential current beneficiary of an electing small business trust (ESBT) and the ESBT will not become a disqualified SH. (Tax Cuts and Jobs Act (TCJA), P.L. 115-97)

Furthermore, certain corporations are ineligible to make S elections, including:[13]

(a) foreign corporations

(b) financial institutions which use the reserve method of accounting for bad debts

(c) certain insurance companies,

(d) current or former domestic international sales corporations, and

(e) former S Corporations who have terminated their S-election within the prior five years.

B. S-Corp Election, Revocation, and Termination: 26 U.S. Code § 1362

1. How to elect.

Entities must expressly elect to be taxed as an S Corporation by filing IRS form 2553.[14] All shareholders must consent to the S Corporation election.[15]

2. When to elect.

An S Corporation election may be made by a small business corporation for any taxable year

(a) at any time during the preceding taxable year, or

(b) at any time during the taxable year and on or before the 15th day of the 3rd month of the taxable year.[16]

However, a late election may be treated as timely under certain circumstances if the IRS determines there was reasonable cause for the failure to timely make such election.[17]

The IRS has also provided late election relief under Rev. Proc. 2013-30. S Corporation elections can be made up to 3 years and 75 days after the date for which the S election is intended to be effective. The election form must state at the top of the document "FILED PURSUANT TO REV. PROC. 2013-30." After the late election relief period has passed, taxpayers can also pursue a private letter ruling.[18]

3. Termination.

An S Corporation election may be terminated voluntarily by revocation or involuntarily. For voluntary terminations, more than half of shares must consent to revocation.[19] As a consequence of voluntary termination, the small business is not eligible to re-elect S Corporation taxation for 5 years after the year the termination is effective.[20]

An S Corporation election may also involuntarily terminate if the entity ceases to qualify as a small business corporation, for example, if the entity has more than 100 shareholders, a shareholder is not eligible to be a shareholder in an S Corporation, or if the S Corporation has more than one class of stock.[21]

III. REASONS TO NOT ELECT S CORPORATION TAXATION

Despite certain advantages of S Corporation taxation, there are many scenarios where an S

[13] IRC § 1361(b)(2)
[14] See https://www.irs.gov/forms-pubs/about-form-2553
[15] IRC § 1362(a)(2)
[16] IRC § 1362(b)(1)
[17] IRC § 1362(b)(5)
[18] Rev. Proc. 2019-1
[19] IRC § 1362(d)(1)
[20] IRC § 1362(g)
[21] IRC § 1362(d)(2)

Corporation election would be inappropriate or detrimental to the taxpayer.

A. What are the client's plans for the future? Does the client plan to exit the business at some point?

1. S-Corp restrictions may discourage potential buyers (i.e. VC firms)

By electing S Corporation taxation, the business may be less attractive as an acquisition target. First, the ownership structure of many venture capital firms may cause an automatic termination of S Corporation status. Many VC's have owners that are themselves partnerships or they may have foreign owners, both which are not eligible owners of an S Corporation.

Second, the ownership of many VC firms (i.e. foreign ownership, greater than 100 owners, etc.) may make structuring an acquisition difficult. For example, the S Corporation requirements may make a stock purchase of an S Corporation difficult to structure. Therefore, an acquirer may be forced to structure the acquisition as an asset purchase (rather than a stock purchase) or the acquirer may purposely terminate the S Corporation status.

Finally, many VC's simply may not want to deal with the complexity of pass through taxation for its owners.

2. Do they want to grow the company to have more than 100 shareholders?

The S Corporation election may place limits on growth of the company. For example, the S Corporation limitation of 100 shareholders can be reached faster than the owners might expect, especially if the owner wants to offer stock as an employee incentive.

Furthermore, problems can arise if the company has already reached the 100 shareholder limit but still needs to raise capital. The company would not be able to bring in new shareholders without terminating the S Corporation status.

3. Restriction to one class of stock.

Potential investors often require preferred returns or separate classes of stock. For example, such investors may require shares that have a preferred return within a distribution waterfall or shares that have preferential voting rights over other shares. The S Corporation restriction to one class of shares does not allow for preferential treatment of some shareholders over other shareholders.

4. Section 1202 deduction only available for C Corporations

Under IRC Section 1202, the gain on the sale of "Qualified Small Business Stock" held for five years or more may be partially or entirely excluded from income. [22] "Qualified Small Business Stock"[23] is defined as any stock in a C Corporation what when originally issued the corporation was a qualified small business.

Section 1202 simply is not available for partnerships and S Corporations. If the owner is thinking about exiting the business in 5-10 years and the business qualifies under Section 1202, the owner should carefully consider whether the potential interim tax reduction provided by S Corporation taxation outweighs the gain exclusion under 1202.

Furthermore, a taxpayer cannot convert from a S Corporation to a C Corporation and have access to Section 1202. The issuing corporation must be a C Corporation at the time of issuance of the stock. That said, the S Corporation converted to a C Corporation can issue new shares for new consideration after the conversion. The new shares may qualify for Section 1202 if at the time

[22] IRC § 1202.

[23] IRC § 1202(c).

of issuance the company is still a qualified small business.

B. Will the client have foreign ownership, now or in the future?

A corporation having a nonresident alien does not qualify as a small business corporation. A nonresident alien is an individual that has not been legally admitted for permanent residence and has not met the substantial presence test.[24] If the entity has nonresident alien shareholders, or may have them in the future, it simply does not qualify for the S Corporation election. Therefore, partnership or corporate taxation must be chosen.

C. Is the intent to reinvest most / all of the funds back in the business?

If the business owner intends to reinvest earnings back in the business, a C Corporation may be a better choice than an S Corporation. With the reduction in the corporate tax rate to 21% under the TCJA, a taxpayer may invest a greater portion of funds in the business as a C Corporation compared to a pass-through entity. The C Corporation advantage is especially important for wealthy taxpayers subject to high marginal tax rates. Additionally, this benefit increases as the growth rate and holding period on the reinvested funds increases.[25]

The following table is a simple example showing this effect. On $100 in earnings, $79 may be reinvested back in the company in a C Corporation whereas only $59 is available to reinvest in an S Corporation.

C Corporation (After 2017 TCJA)

Taxable Income	$100.00
Corporate Rate	21%
Corp Tax Liability	$21.00
Cash Avail to Reinvest	$79.00

S Corporation (After 2017 TCJA)

Taxable Income	$100.00
Corporate Rate	0%
Corp Tax Liability	$0.00
Cash Avail to Shareholders	$100.00
Individual Rate	37.0%
Net Investment Income Rate	3.80%
Individual Tax Liability	$40.80
Total Tax Liability	$40.80
Cash Avail to Reinvest	$59.20

D. Will the client own real estate or other appreciating assets?

Like C Corporations, S Corporation are subject to tax on certain built-in-gains.[26] Built-in-gains ("BIG") are defined as the difference between the fair market value of the S Corporation assets and the aggregate adjusted basis of such assets at that time. BIGs are recognized on the sale or disposition of an asset.

For any tax year in which there is a BIG, there is an additional tax imposed by applying the highest marginal tax rate (currently 21% due to TCJA) to the BIG. Although the taxpayer never wants to

[24] IRC § 7701(b)(1)(B).

[25] The ability to stockpile assets in the C-corp is limited to the accumulated earnings tax (Section 531). Safe harbor of $250k (Section 532(c)(2)) unless there are provable business needs.

[26] IRC § 1374.

incur the BIG tax, prior to the reduction in the corporate tax rate due to the TCJA the taxpayer would incur BIG tax at a much higher rate.

The imposition of the BIG tax is limited in the following ways:

1) The BIG tax only applies to asset dispositions during the first 5-year period after the effective date of the S Corporation tax election[27];

2) The BIG tax does not apply to any corporation which has always been taxed as an S Corporation[28];

3) The BIG tax is also limited to income tax that would have been incurred as a C-Corporation. Therefore, a taxpayer can avoid the BIG tax if the entity has no taxable income for the first 5 years.

Because of the BIG tax, it is generally detrimental to hold appreciating assets (or assets that are subject to depreciation) in a S Corporation, especially if the owner intends to dispose of the assets within the 5 year recognition period (i.e. selling the assets, distributing the assets in-kind to the shareholder, gifting the property to a child, etc.). Under partnership taxation, on the other hand, there is no immediate tax impact of distributing the property from the partnership.

Note that a real estate "flipper" is less effected by the BIG tax because they do not intend to buy and hold the property for a long period of time. Additionally, property developers are subject to both ordinary income tax and self employment tax on the proceeds of a real estate sale.

E. Will the client's earnings outweigh the costs of maintaining the S-election?

From a practical standpoint, the taxpayer will incur additional costs to maintain an entity with an S Corporation election. For example, the taxpayer will be required to run payroll to pay salaries from the S Corporation. Typical costs for online payroll software costs approximately $25-200 per month. Additionally, the S Corporation will also require an 1120s tax return each year. According to the 2016-17 NSA Income and Fees of Accountants and Tax Preparers in Public Practice Survey Report, the average cost of an 1120s tax return was $809.

Although the S Corporation election can result in a significant reduction in self-employment tax, the costs of maintaining the must be considered when deciding if the tax savings outweighs the additional costs, especially for disregarded entities that do not require payroll or a federal income tax return.

F. Is the client a high income investor?

High income passive investors in the highest tax brackets will not see significant benefits from pass-through S Corporation taxation, especially if the businesses do not qualify for the 20% deduction. In 2020 the highest individual marginal tax rate is 37% (which will revert back to 39.6% in 2026). In a C Corporation, however, the investor would incur an effective tax rate of 39.8% (21% at the corporation level + 23.8% for dividends*79%). Note that an active investor receiving W-2 wages will potentially see a self-employment tax reduction in a S Corporation compared to partnership taxation.

G. Will the client want to make disproportionate distributions to certain Shareholders? Disproportionate allocations of profits and losses?

S Corporations cannot disproportionately allocate profit among the shareholders. Distributions of

[27] IRC § 1374(d)(7).

[28] IRC § 1374(c)(1).

profit must be proportionate according to the shareholder's ownership in the entity.

The proportionate distribution rule is based on the requirement of one class of stock[29]. Tax regulations provide that "a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds." Therefore, an S Corporation cannot have disproportionate distributions because that would imply more than one class of stock.

Deemed disproportionate distributions can result in inadvertent termination of S-Corp status. Limited liability companies and limited partnerships that elect S Corporation taxation should evaluate partner's rights carefully within the partnership agreement to determine if multiple classes of stock are created inadvertently (for example, liquidating distributions based on capital accounts rather than ownership of units).

Partnerships can make disproportionate distribution without any issues. Partners may desire to distribute profit disproportionately for a variety of practical reasons, such as when one partner contributes more to the partnership than other partners of equal ownership.

H. Does the client want to offer different retirement benefits to select employees?

Contributions must be the same to all eligible employees of the S Corporation retirement plan. A shareholder cannot make a large contribution to their retirement plan without making the same contribution to the retirement plans for all eligible employees. For example, the owner / physician in a doctor's office may desire to make a large contribution to their SEP IRA. If the entity is taxed as an S Corporation, they would also have to make the same proportionate distribution to the staff employed by the entity.

I. Will the client use the stock of the company for estate planning purposes?

From an estate planning standpoint, S Corporations are not ideal. First, the single class of stock requirement makes succession planning more difficult. Parents often transfer ownership in the family business by making gifts or sales of stock to their children. The requirement of one class of stock limits the options that are available to the parent passing S Corporation stock ownership to their children. Notwithstanding the single class of stock rule, IRS Regulations do provide that the entity can issue voting and non-voting stock, which if identical in all other respects, including distributions and liquidations, will not be treated as different classes of stock within the meaning of § 1361(b)(1)(D).[30]

Second, only certain kinds of trusts can hold S Corporation stock such as grantor trusts, qualified revocable trusts, qualified subchapter S trusts (QSST)[31] and electing small business trusts (ESBT)[32]. Grantor trusts become non-grantor trusts (and therefore ineligible S Corporation shareholders) upon the death of the grantor. In this case, the grantor trust can only hold S Corporation shares for at most 2 years after the date of death of the deceased grantor.[33] Similarly, a testamentary trust created by a Last Will and Testament can hold S Corporation stock for at most 2 years after the date in which the shares were transferred to such trust.[34]

These limitations make it difficult to implement complicated estate planning techniques used by

[29] Section 1.1361-1(l)(1) of the Income Tax Regulations

[30] IRC § 1361(b)(1)(D) and Section 1.1361-1(l)(1) of the Income Tax Regulations.

[31] IRC § 1361(d)(1).

[32] IRC § 1361(c)(2)(A)(v).

[33] IRC § 1361(c)(2)(A)(ii).

[34] IRC § 1361(c)(2)(A)(iii).

parents to transfer their business to their children and maintain the S Corporation election.

J. Fringe benefits

Businesses often use fringe benefits to compensate employees. In general, fringe benefits are taxable income to the employee, with the exception of certain fringe benefits.[35] Excludable fringe benefits include, among others, the cost of group-term life insurance, amounts paid for or to an accident or health plan, health savings accounts, and meals and lodgings furnished for convenience of the employer.

In general, certain fringe benefits provided by a S Corporation are not taxable to employees. However, employees that own 2% or greater of a company are treated like partners in a partnership for the purposes of determining taxability on fringe benefits, rather than employees[36]. In these cases, most fringe benefits are taxable to the employee, including premium payments for employee owned life insurance, health insurance premiums, accident insurance premiums, disability insurance premiums, long-term care insurance premiums, personal use of a company car, lodging, and meals. For employees that own 2% or greater of the company shares, such fringe benefits are recognized as wages and included in the employee's W-2 wages, subject to regular federal withholding and employment tax withholding. Furthermore, if the S Corporation fails to properly report such fringe benefits as compensation, the IRS may determine that unequal distributions have been made to such shareholder (violating the single class rule), potentially terminating the S Corporation election.

IV. CONCLUSION

With the high C Corporation tax rates prior to the TCJA, the benefits of pass through taxation and a reduction in self-employment tax made the election of S Corporation taxation very attractive in many cases. However, given the new corporate tax rate of 21% and the 199A tax deduction, the analysis has become more complex as to determine advisability of the S Corporation election. Furthermore, other factors such as treatment of fringe benefits, retirement planning, estate planning, and the short and long-term goals of the business owner can become important in the S Corporation decision.

Politics must also be considered in the decision to elect S Corporation taxation. With the presidential election in 2020 and congressional election in 2022, a dramatic shift in tax policy could affect tax planning and strategy. Because S Corporation elections cannot be resubmitted for 5 years after revocation, a business owner could be stuck with a bad choice until the 5-year term runs. Most of the provisions of TCJA are set to automatically expire after 2025, which will again alter the analysis. The 21% corporate tax rate is permanent, but even that could change if the elections result a change in power in Washington.

Given this uncertainty, is it wise to make significant structural tax changes? Perhaps the best approach is to use multiple entities to segregate business units to optimize overall taxation for the client.

[35] IRC § 132.

[36] IRC § 1372

Now, for the Rest of the Story: Choice of Entity & Acquisition Structuring after the '17 TCJA

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Tax Law In A Day
Houston, TX
February 7, 2020

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Tax Cut and Jobs Act of 2017 (TCJA)

Changes Relevant to Partnership Transactions

- • Section 168(k) (expensing) and Final & Proposed Regulations
- • Section 199A (pass through deduction) and Regulations
- • Section 163(j) (limit on interest deduction) and Proposed Regulations
- Other Relevant Statutory Changes
- • Section 1061 (carried interest)
- • Section 708(b) (repeal of technical termination rule)
- • Section 1221(a)(3) (extension of self-created property rules to patents, etc.)

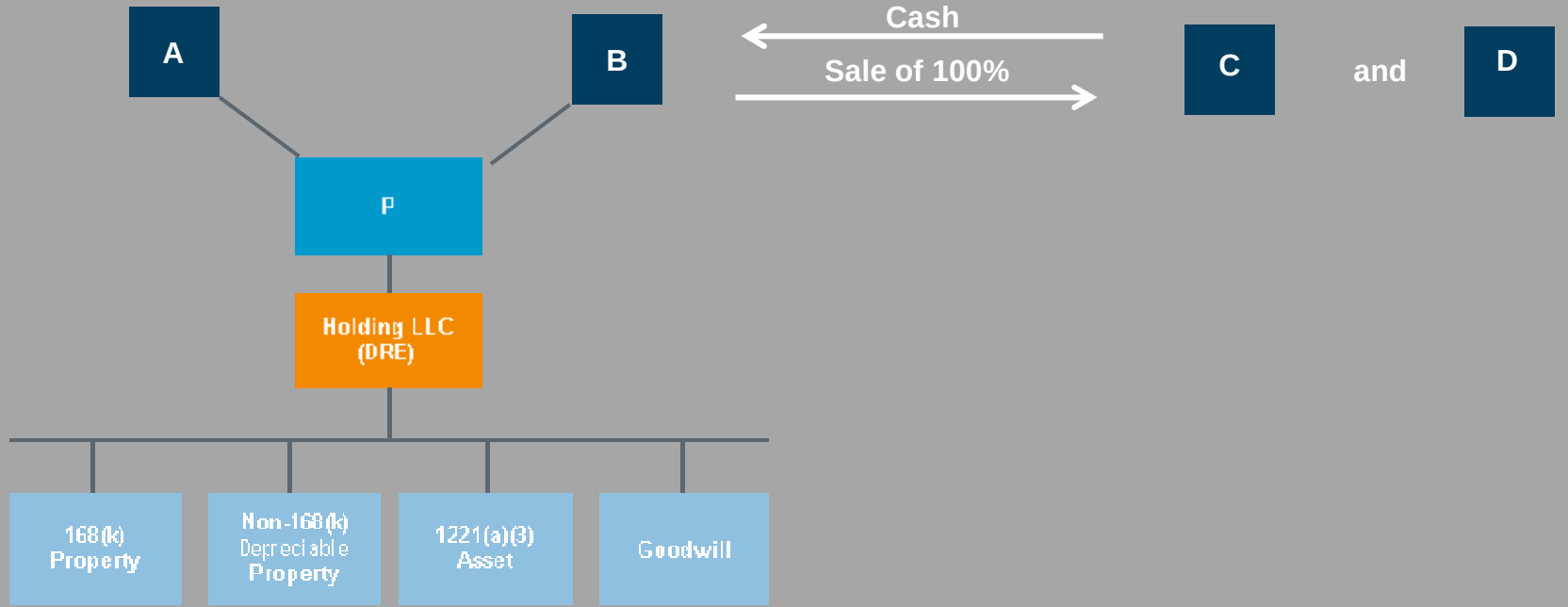
Post TCJA Partnership Issues

- Three common ways to get a tax basis step up in the partnership acquisition context
- • Buy an interest in an existing partnership
- – Partner gets step up (Section 743 basis)
- • Partnership redeems an existing partner
- – Partnership may get a partial step up (Section 734 basis)
- • Buy assets and hold in partnership form (or buy an interest in a DRE in a Rev.
- Rul. 99-5, Situation 1 transaction)
- – Partnership gets step up (actual asset basis)

Post TCJA Partnership Issues

- The three forms of transactions are treated differently under various rules
- • New 100% expensing for tangible property under Section 168(k)
- • New interest deductibility limitations under Section 163(j)
- • New 20% deduction under Section 199A for certain types of pass-through income
- • New carried interest holding period requirement of Section 1061
- • Possible differences for the seller in the application of Section 1235
- Given the tax stakes, the question is whether form will always be respected

Purchase of 100% of Partnership Interests or Assets



Purchase of 100% of Partnership Interests or Assets

- Basic Facts:
  - P currently has two partners (A and B).
  - C and D (unrelated individuals) wish to purchase P's entire business for cash.
  - Business is eligible for Section 199A deduction.
  - P has four assets (as shown).
- Each asset has basis of 50x and value of 100x
- Non-168(k) depreciable property has 5 years of depreciation remaining.
- Inside basis generally equals outside basis.
- Should the transaction be structured as a purchase of 100% of the partnership interests or a purchase of assets?

Purchase of 100% of Partnership Interests or Assets

168(k) Property:

– If actual asset sale, full fair market value of eligible assets expensed; if interest sale with Section 754 election, only gain inherent in the eligible assets is expensed pursuant to Section 743(b).

• Non-168(k) Depreciable Property:

– If actual asset sale, depreciation recovery period starts over for “entire” asset.

– If partnership interest sale, existing basis is depreciated over remaining historic recovery period but Section 743 SBA is generally depreciated over a new recovery period except as to 704(c) layers subject to remedials.

Sections 1221(a)(3) & 1235

- • Section 1221(a)(3) now includes any “patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical or artistic composition, a letter or memorandum, or similar property, held by a taxpayer whose personal efforts created such property.”
- Section 751(d) treats any property that would be considered “property other than a capital asset and other than property described in section 1231” as a hot asset.
- Under section 1235, a transfer of a patent (or patentable property) is “considered the sale or exchange of a capital asset held for more than one year ” if the transferor is an individual whose efforts created the property or if the transferor is an individual (other than an employer of the creator) who acquired the patent before it was reduced to practice.

Sections 1221(a)(3) & 1235

- Congress did not repeal Section 1235 when it added patents to Section 1235.
- Pursuant to Reg. Section 1.1235-2(d)(2), although a partnership cannot qualify as an individual whose efforts created the property, individual partners can be holders to the extent of their pro rata interests in a patent.
- Query whether, by virtue of Reg. Section 1.1235-2(d)(2), the sale of a partnership interest in a partnership holding a self-created patent would avoid 751(a) treatment, or whether Reg. Section 1.1235-2(d)(2) is limited to a sale by the partnership of the patent.

Purchase of 100% of Partnership Interests or Assets

- Section 199A– Section 743 adjustment does not give rise to UBIA.
- Bonus Basis Adjustment ("BBA"):

– If interests are sold rather than assets, entity remains in existence and buyers indirectly inherit BBA adjustments. Note that this is the case even in the case of a 100% acquisition that is otherwise treated as an asset purchase for tax purposes.

- Section 1061:

– If purchase interests rather than assets (other than in a 99-6 transaction), no restart in holding of assets (relevant if, for example, C receives a profits interest governed by Section 1061).

Section 163(j) issues

- In the partnership context, Section 163(j) is all about location, location, location.
- If step-up is effected as a Section 743 adjustment to the partners (C and D) rather than a step up in partnership assets, will tend to increase Section 163(j) capacity for interest expense on partnership level (P) debt but potentially reduce Section 163(j) capacity for interest expense on partner (C and D) level debt.

Purchase of 100% of Partnership Interests or Assets

- Section 734 vs. Section 743:

– If the transaction is structured as a purchase of partnership interests and financed with partnership level debt, the distribution of the debt proceeds to sellers (A and B) may give rise to a Section 734 adjustment.

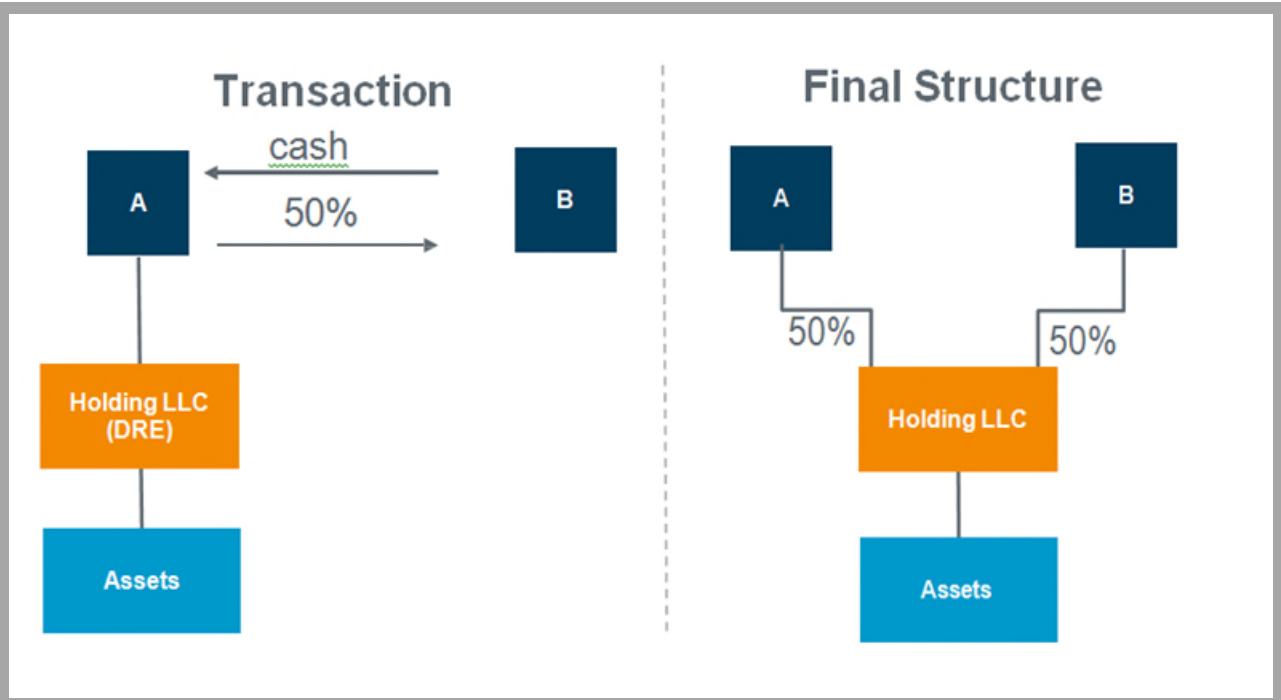
– Consider ordering impact on the size of the Section 734 and 743 adjustments.

- Consider:

– Impact under Section 168(k)

– Impact on sellers.

Rev. Rul. 99-5: Buying a Partial interest in a DRE



Rev. Rul. 99-5: Buying a Partial interest in a DRE

PARTNERSHIP FORMED IN THE TRANSACTION

EXISTING OWNER RETAINS AN INTEREST

- Rev Rul. 99-5 treatment – B's purchase of 50 % of A's ownership interest is treated as purchase of a 50 % undivided interest in each asset and (immediately thereafter) a contribution of such undivided interests to a partnership.
- • Section 168(k) deduction at transferor level. Treas.Reg. Sec. 1.168-2(g)(1)(iii).
- • Result: new partnership, but undivided half interest in assets were sold.

Rev. Rul. 99-5: Buying a Partial interest in a DRE

Intent of the proposed regulations seems to be that Holding LLC takes the Section 168(k) deduction.

- If treat property as first sold to B and C, are they treated as having placed in the property in service?
- Is the property treated for certain Section 168(k) purposes as sold directly to Holding LLC?
  - See Prop. Reg. 1.168(k)-2(b)(3)(iii)(C). (2019)
  - Solely for purposes of 163(k)(2)(E)(ii) (and Treas. Reg. 1.168(k)-2(b)(3)(iii)(A)),, the relationship between parties under section 179(d)(2)(A) or (B) in a series of related transactions is tested immediately after each step in the series, and between the original transferor and the ultimate transferee immediately after the last transaction in the series. A series of related transactions may include, for example, a transfer of partnership assets followed by a transfer of an interest in the partnership that owned the assets; or a disposition of property and disposition, directly or indirectly, of the transferor or transferee of the property.

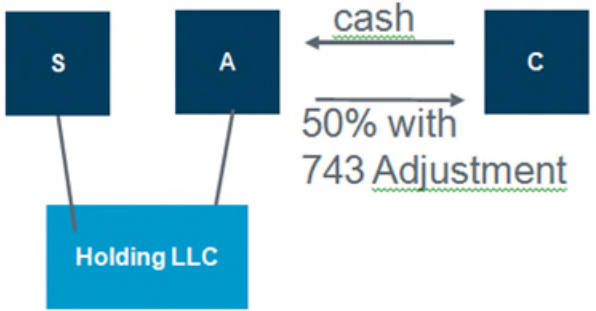
Buying a Partial interest in a DRE

Beginning

Transactional Steps

Step 1:
S (an affiliate of A) becomes an owner of Holding LLC and Holding LLC becomes a partnership (various ways of doing this).

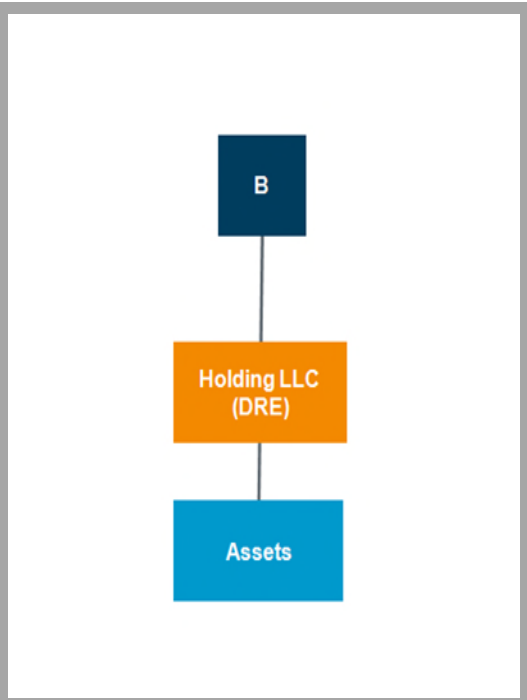
Step 2:
A sells a 50% interest in Holding LLC to C.



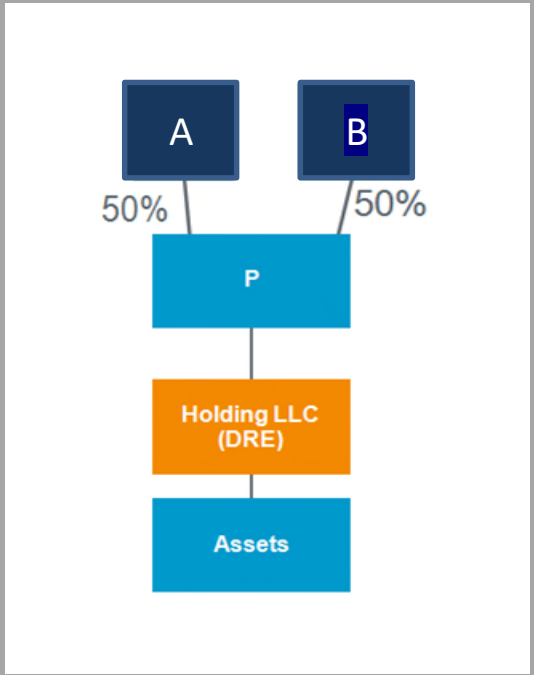
PARTNERSHIP FORMED BEFORE THE SALE

- Prop. Reg. 1.168(k)-2(b)(3)(iii)(C) should not apply because the relationship between parties under section 179(d)(2)(A) or (B).
  - Solely for purposes of 163(k)(2)(E)(ii) (and Prop. Reg. 1.168(k)-2(b)(3)(iii)(A)), the relationship between parties under section 179(d)(2)(A) or (B) in a series of related transactions is tested immediately after each step in the series, and between the original transferor and the ultimate transferee immediately after the last transaction in the series. A series of related transactions may include, for example, a transfer of partnership assets followed by a transfer of an interest in the partnership that owned the assets; or a disposition of property and disposition, directly or indirectly, of the transferor or transferee of the property.

Buying a Partnership Interest



Buying a Partnership Interest



Buying a Partnership Interest

- If transaction structured as simple sale of 50% of the partnership interests, same basic result as discussed previously when selling 100% of the partnership interests to multiple buyers.

– As a result of Section 743, expensing treatment to C as to SBA allocable to assets eligible for expensing.

– Partnership remains alive. Same treatment under BBA rules and Section 199A as sale of all the interests.

• What if sale of undivided interest in assets would be better (e.g. because of expensing)?

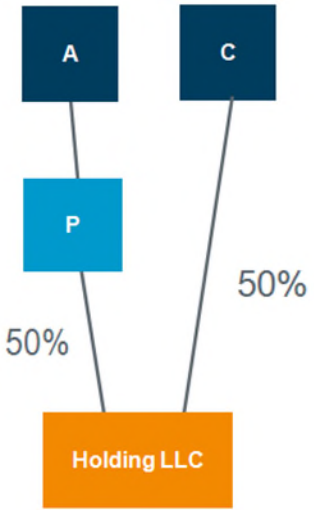
Buying an Undivided Interest in Partnership Assets

Transactional Steps

Step 1:
P sells 50% interest in Holding LLC (DRE) to C; Holding LLC becomes a partnership.

Step 2:
P redeems out B's interest in P for cash received from C; P is now a disregarded entity owned by A so that A is treated as a partner in Holding LLC (now a partnership).

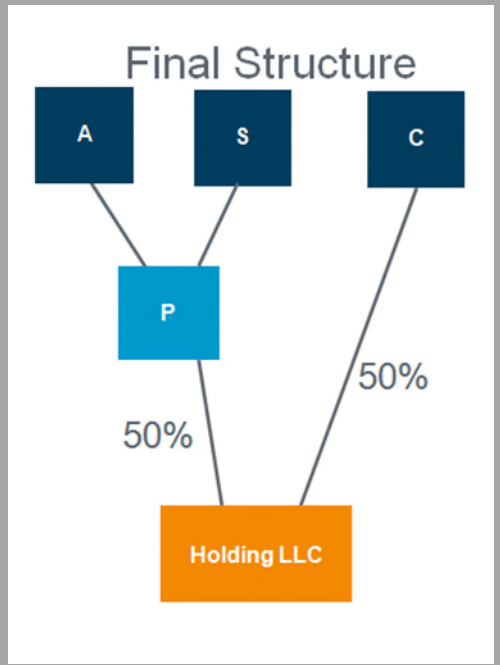
Final Structure



Buying an Undivided Interest in Partnership Assets

- Old Partnership Terminates
- Can P allocate all the income of the sale to B? Is this allocation stuffing or like stuffing? Does it matter that this sale is of an undivided interest in all assets?
- Is this viewed as sale of undivided interest in assets to C followed by contribution to a new partnership, or is Holding LLC just a continuation of P, and the transaction is recast to be simply a sale of B's interest in P to C? See Section 708(a) and 708(b)(1).

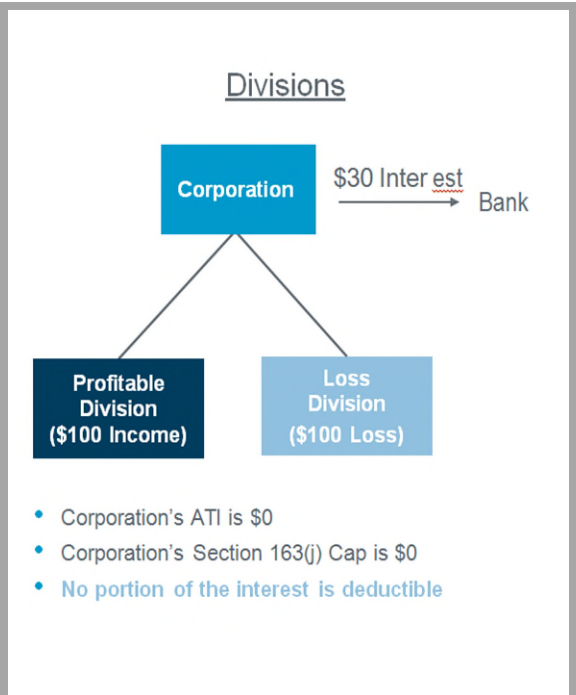
Buying an Undivided Interest in Partnership Assets



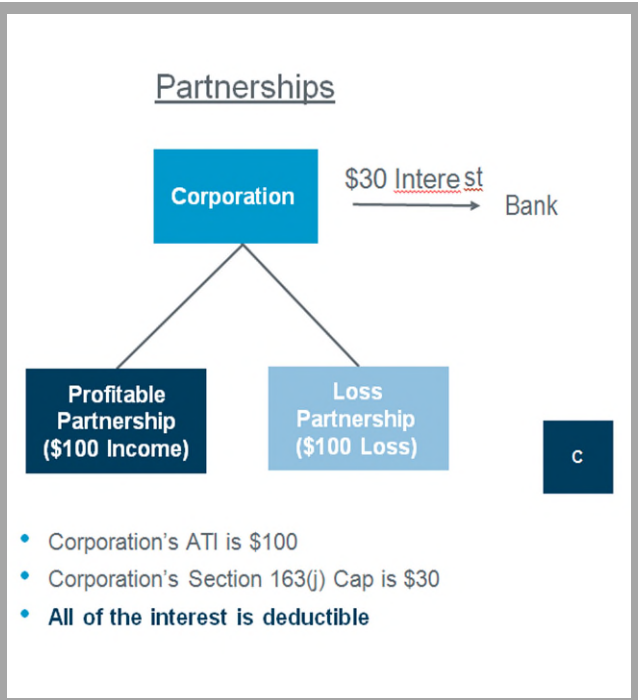
Buying an Undivided Interest in Partnership Assets

- Old Partnership survives
- Does this structure solve the continuation issue?
- If the form is respected, we have a Rev. Rul. 99-5 (sit. 1) transaction as to DRE, and Holding LLC treated as a new partnership.
- Same allocation question.

Section 163(j) Planning



Section 163(j) Planning



Section 163(j) Planning

- Two basic Takeaways
- Structure to increase Section 743 adjustment and reduce Section 734 adjustment
- ✓Allows for improved treatment under Section 163(j)
- ✓Also better result under Section 168(k) expensing than a Section 734 adjustment
- ✓Also creates QBIA under Section 199A
- Location of debt
- ✓Borrow debt at or above all of the earnings to maximize ATI for purposes of Section 163(j) (consider effect on real estate exception)
- ✓House the Section 743 adjustment in a holding partnership

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STATE TAX ISSUES FOR TEXAS NONPROFIT ORGANIZATIONS

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PUBLICATIONS

Editor, Family Foundation Advisor

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I. INTRODUCTION

Although the terms "nonprofit" and "tax-exempt" often are used interchangeably, they are not synonymous. Under Texas law, a nonprofit corporation can be created for any lawful purpose not prohibited by the Business Organizations Code.[1] These purposes include:

- serving charitable, benevolent, religious, eleemosynary, patriotic, civic, missionary, educational, scientific, social, fraternal, athletic, aesthetic, agricultural, and horticultural purposes;
- operating or managing a professional, commercial, or trade association or labor union;
- providing animal husbandry; and
- operating on a nonprofit cooperative basis for the benefit of its members.[2]

Not all of the purposes for which a nonprofit corporation can be formed would qualify the organization for federal tax-exempt status, and a nonprofit corporation may be subject to certain state taxes, depending on its activities. This article examines the application of the Texas margin tax; sales and use tax; hotel occupancy tax; motor vehicle sales, rental, and use tax; and property tax to various types of nonprofit corporations and discusses how structuring decisions may improve tax efficiency.

II. TEXAS MARGIN TAX

Most Texas business entities (including nonprofit corporations) are subject to Texas margin tax unless an exception applies. Nonprofit corporations that have requested and been granted an exemption from the Comptroller do not have to file margin tax annual reports, including the Public Information Report or Ownership Information Report. However, if the entity has not requested or been granted an exemption, it must file all reports.[3] Note that nonprofit periodic reports are required for organizations that are exempt from margin tax. The author has worked with a number of nonprofit corporations that obtained recognition of their federal (but not state) tax-exempt status and that had their corporate privileges revoked as a result of their (unknowing) failure to file margin tax reports. When forming new entities, practitioners should make sure to file for state, as well as federal tax-exempt status. And, when undertaking a representation of a new tax-exempt client, a practitioner should check the Texas Comptroller's and Secretary of State's websites to make sure the organization has not undergone a tax forfeiture or had its corporate privileges forfeited for failure to file a nonprofit periodic report.

An entity that has been granted exemption from margin tax but that has unrelated business taxable income nevertheless is exempt from margin tax. It does not need to file a margin tax report based on unrelated business income.[4]

A. Margin Tax Exemption Based on Federal Exemption

Entities that are exempt from federal income tax under certain provisions of the Internal Revenue Code, including:

- §501(c)(3) (religious, charitable, scientific, literary, educational, amateur sports, prevention of cruelty to children or animals)
- §501(c)(4) (social welfare)
- §501(c)(5) (labor, agricultural, horticultural)
- §501(c)(6) (business leagues, chambers of commerce, boards of trade)
- §501(c)(7) (pleasure, recreation)
- §501(c)(10) (fraternal societies)[5]

are exempt from margin tax.

These organizations can obtain recognition of their exemption from margin tax based on their federal exempt status. To apply for margin tax exemption based on the federal exempt status, an organization must complete and submit Form AP-204, Texas Application for Exemption – Federal and All Others and must include a copy of its federal determination letter. [6] The organization name on the determination letter must match the organization's legal name as listed in the Articles of Incorporation, Certificate of

[1] Tex. Bus. Org. Code §22.051.
[2] Tex. Bus. Org. Code §2.002.
[3] Texas Comptroller, Franchise Tax Frequently Asked Questions, Exemptions (*available at* https://comptroller.texas.gov/taxes/franchise/faq/exemptions.php).
[4] *Id.*
[5] Tex. Tax Code §171.063(a)(1).
[6] Tex. Tax Code §171.063(c).

Formation or governing document. If the determination letter was issued more than four years ago, the organization must include a current verification letter obtained from the Internal Revenue Service.

If the Internal Revenue Service has not issued a corporation its determination letter, evidence establishing the corporation's provisional margin tax exemption is sufficient if the corporation timely files with the Comptroller evidence that it has applied in good faith for recognition of its federal exemption. The evidence must be filed not later than the 15th month after the last day that is (1) a calendar month; and (2) nearest to the date the corporation was formed.[7] If the corporation's federal exempt status ultimately is denied, the corporation is not subject to any penalty from the date of its formation to the date of final denial.[8]

Whether a corporation obtains actual or provisional margin tax exemption, the exemption is effective as of the date the corporation was formed.[9] If a corporation's federal exempt status is revoked, its margin tax exemption is withdrawn as of the effective date of the federal revocation. The effective date of the withdrawal is considered the corporation's beginning date for purposes of determining its privilege periods.[10]

i. LLCs Pose a Trap for the Unwary

Under federal tax law, a single-member LLC ordinarily is a disregarded and is treated as a division of its parent. This rule permits tax-exempt organizations to avail themselves of the state law liability protection that an LLC provides without having to obtain separate federal tax-exempt status for the LLC. However, it is important to recognize that the legal formation of an entity—not the entity's treatment for federal income tax purposes—determines filing responsibility for Texas margin tax. Each taxable entity that is organized in Texas or doing business is subject to margin tax (even if it is treated as a disregarded entity for federal income tax purposes) and is required to file margin tax reports.[11] Because the LLC does not have a federal determination letter issued to it, it will not be able to apply for margin tax exemption based on its federal tax-exempt status.

Depending on the nature of the activities that would be conducted by the LLC, it might make sense to use a limited partnership (with a single-member LLC as the general partner) rather than an LLC. Assuming all the limited partner interests are owned by the tax-exempt parent, the limited partnership will be disregarded for purposes of federal income tax. Unlike LLCs, limited partnerships can qualify as "passive entities," which are exempt from margin tax, provided that:

(a) the entity's federal gross income consists of at least 90 percent of passive income, including dividends, interest, distributive shares of partnership income, capital gains from the sale of real property, gains from the sale of commodities traded on a commodities exchange, gains from the sale of securities; and royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests; and

(b) the entity does not receive more than 10 percent of its federal gross income from conducting an active trade or business.[12]

A limited partnership that qualifies as a passive entity is not liable for margin tax, but it must file an annual No Tax Due Report to affirm that it qualifies as passive for the period upon which the tax is based. A passive entity is not required to file an Ownership Information Report.[13] If the limited partnership is not registered and is not required to register with the Secretary of State or Comptroller's office, it is not required to file a margin tax report.[14]

ii. Consider No-Tax Due Threshold and Margin Tax Rate When Making Structuring Decisions

When taking margin tax into account for purposes of making structuring decisions, it is important to consider the generous no-tax due threshold. Entities that have total revenue below this

[7] Tex. Tax Code §171.063(d).
[8] Tex. Tax Code §171.063(f).
[9] Tex. Tax Code §171.063(e).
[10] Tex. Tax Code §171.063(g).
[11] Texas Comptroller, Franchise Tax Frequently Asked Questions, Taxable Entities (*available at* https://comptroller.texas.gov/taxes/franchise/faq/taxable-entities.php).
[12] Tex. Tax Code §171.0003.
[13] Texas Comptroller, Franchise Tax Frequently Asked Questions, Passive Entities (*available at https://comptroller.texas.gov/taxes/franchise/faq/passive-entities.php).*
[14] *Id.*

threshold (currently $1,130,000) are eligible to file No Tax Due Report. If the tax due is less than $1,000 but annualized total revenue is greater than the no-tax due threshold amount, the entity must file a Franchise Tax Report or EZ Computation Report but does not owe any tax.[15] Further, given that current margin tax rates are less than 1%, margin tax planning does not necessarily need to override business and practical considerations.

B. Margin Tax Exemption Based on Activities

As a practical matter, it is easier for a nonprofit corporation to obtain margin tax exemption based on its federal exempt status. The organization need only submit Form AP-204, Texas Application for Exemption – Federal and All Others and a copy of its federal determination letter. The Comptroller will grant a margin tax exemption with minimal review and inquiry. However, many organizations that enjoy federal exempt status do not have determination letters issued in their names. Some—like churches and their integrated auxiliaries, homeowners associations, disregarded entities, and very small (under $5,000 gross receipts) organizations—are not required to apply for recognition of their federal exemption. Others are covered by group exemption letters under a central organization that has not gotten its group exemption established on the Comptroller's records. Further, the tax exemption that is granted on the basis of federal exemption only applies to margin (and in applicable cases, sales) tax. It does not make the organization exempt from hotel occupancy tax even if the organization actually qualifies for exemption.

An organization that does not have a federal determination letter—or for which hotel occupancy tax would be a meaningful burden—and that qualifies to do so should file for margin tax exemption based on one of the separate statutory bases for exempt status. Because the statutory exemptions contain their own specific requirements above and beyond federal tax exemption, the applications require more information than is required with Form AP-204.

Note: the exemption statutes are written with reference to "a corporation." Section 171.088 contains a savings provision that provides, "an entity that is not a corporation but that, because of its activities, would qualify for a specific exemption under this subchapter if it were a corporation, qualifies for the exemption and is exempt from the tax in the same manner and under the same conditions as a corporation.

In order to apply for exemption on the basis of a separate statute, an organization must submit the required form (generally AP-204, unless noted below) and all required documentation as listed in the application. If the organization is unincorporated, it must include a copy of its governing document, such as the bylaws or constitution. The document must show that the organization is nonprofit. If the organization is incorporated, the Comptroller will review the corporation's formation documents on file with the Texas Secretary of State to verify that the corporation's purpose is consistent with the requirements of the specific statute. Non-Texas corporations must also include a copy of the corporation's formation documents and a current Certificate of Existence issued by their state of incorporation.[16]

The following is a non-exhaustive list of the more common bases for exemption, with detail derived from Texas Comptroller Publication 99-122, "Guidelines to Texas Tax Exemptions".

1. Agricultural Organizations

A nonprofit corporation organized to hold agricultural fairs and encourage agricultural pursuits is exempt from margin tax.[17]

2. Chambers of Commerce

A nonprofit chamber of commerce is exempt from margin tax if it represents at least one Texas city, county, or geographic area and promotes the general economic interest of all commercial enterprises in the area it represents.[18] The exemption does not include organizations such as trade associations or business leagues that serve a single line or closely related lines of business within a single industry.

3. Charitable Organizations

A nonprofit charitable organization is exempt from margin tax if it devotes all or substantially all of its activities to the alleviation of poverty, disease, pain and suffering by providing food, drugs, medical treatment, shelter, clothing, or psychological

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[15] *See generally,* Texas Comptroller Franchise Tax Frequently Asked Questions, Reports and Payments (*available at* https://comptroller.texas.gov/taxes/franchise/faq/reports-payments.php).

[16] *See generally, Texas Comptroller, Publication 99-122, "Guidelines to Texas Tax Exemptions"* (May 2018) (*available at* https://comptroller.texas.gov/taxes/publications/96-1045.php).

[17] Tex. Tax. §171.060.

[18] Tex. Tax. §171.057.

counseling directly to indigent or similarly deserving individuals for little or no fee.

The organization's funds must be derived primarily from sources other than fees or charges for its services. Organizations with a broader range of activities will not qualify for exemption as charitable organizations.[19]

To apply for exemption a charitable organization, an organization must complete Form AP-205.

1. Conservation Organizations

Organizations organized solely to educate the public about the protection and conservation of fish, game, other wildlife, grasslands or forests are exempt from margin tax.[20]

2. Convalescent Homes for the Elderly

A nonprofit organization organized to provide convalescent housing for persons who are at least 62 years old or who are handicapped or disabled is exempt from margin tax.[21]

3. Educational Organizations

A nonprofit educational organization is exempt from margin tax if it is devoted solely to systematic instruction (particularly in the commonly accepted arts, sciences and vocations) with a regularly scheduled curriculum, faculty and enrolled student body or students in attendance at a place where the educational activities regularly occur.

An organization with activities consisting solely of public discussion groups, forums, panels, lectures or other similar programs also will qualify if the presentations provide instruction in the commonly accepted arts, sciences and vocations.[22]

Educational organizations apply for exemption using Form AP-207.

1. Homeowners' Associations

A homeowners' association that is a nonprofit corporation organized and operated primarily to obtain, manage, construct and maintain the property in or of a residential condominium or residential real estate development that is legally restricted for use as residences (the property cannot be used for any commercial activity) is exempt from margin tax if the individual owners of the lots, residences or residential units have at least 51 percent voting control of the association.

A homeowners' association will not qualify for this exemption if voting control is held by a single individual, family or by one or more developers, declarants, banks, investors or similar parties. [23]

Homeowners organizations apply for exemption using Form AP-206.

2. Religious Organizations

A nonprofit religious organization is exempt from margin tax if it is an organized group of people regularly meeting at a particular location with an established congregation for the primary purpose of holding, conducting and sponsoring religious worship services according to the rites of their sect.[24]

Organizations that simply support and encourage religion as an incidental part of their overall purpose, or that further religious work or teach their membership religious understanding, will not qualify for exempt status under this category.

Religious organizations apply for exemption using Form AP-209.

1. Student Loan Funds and Scholarship Organizations

A organization organized solely to provide student loan funds or scholarships is exempt from margin tax.[25]

2. Youth Athletic Organizations

A youth athletic organization is exempt from sales and franchise taxes. Qualifying organizations must be engaged exclusively in providing athletic competition among persons under 19 years of age.[26]

III. TEXAS SALES AND USE TAX

A. In General

The Texas Sales and Use Tax (herein referred to as "sales tax") applies to sales of tangible personal property and to taxable services (collectively, "taxable items").[27] Sales tax is collected by the seller of the taxable item and remitted to the Texas Comptroller.[28]

[19] Tex. Tax §171.062.
[20] Tex. Tax §171.064.
[21] Tex. Tax §171.067.
[22] Tex. Tax §171.061.
[23] Tex. Tax §171.082.
[24] Tex. Tax §171.058.
[25] Tex. Tax §171.087.
[26] Tex. Tax. 171.057.
[27] Tex. Tax Code Ann. §151.051.
[28] Tex. Tax Code Ann. §151.052.

Certain entities are exempt from paying sales tax.[29] In particular, a nonprofit organization that applies for and obtains a determination letter or a group exemption ruling letter from the Internal Revenue Service that states that the organization qualifies for exemption from federal income tax under I.R.C. §501(c)(3), (4), (8), (10), or (19) may qualify for sales tax exemption.[30] In addition, as discussed in connection with the margin tax there are a number of separate statutory bases for exemption.

For the exemption to apply to a particular transaction, the item sold, leased, rented, stored, used, or consumed must relate to the purpose of the exempted organization and the item must not be used for the personal benefit of a private stockholder or individual.[31]

B. Obtaining Exempt Status

In order to obtain exemption from sales tax, an organization must apply for and obtain a letter of exemption from the Comptroller.[32] In general, the same application for exemption from margin tax will result in exemption from sales tax, if available. Note that organizations that are exempt from margin tax on the basis that they are exempt from federal income tax under I.R.C. §501(c)(2), (5), (6), or (7) are not exempt from sales tax.

In its application, the organization must submit to the Comptroller a written statement that details the nature of the activities conducted or to be conducted as well as provide a copy of the bylaws, constitution and any applicable trust agreement.[33] If the organization is a corporation, it must include a copy of the articles or incorporation and any related amendments.[34] In addition, if the organization is claiming exemption on the basis that it has been recognized under I.R.C. §501(c)(3), (4), (8), (10), or (19), the organization must include a copy of all pages of a determination letter or a group exemption ruling letter from the Internal Revenue Service.[35]

C. Purchases

The purchase, lease, or rental of a taxable item that relates to the purpose of the exempt organization is not subject to sales tax when the authorized agent of the organization pays for the item and provides the vendor with an exemption certificate.[36] When buying an item to be donated to an exempt organization, an individual can give the seller an exemption certificate in lieu of paying tax. If the individual uses the item before donating it, however, the exemption is lost and tax is due.[37]

An employee of an exempt organization cannot claim an exemption when buying taxable items of a personal nature, even if the organization gives an allowance or reimbursement for such items. For example, meals, toiletries, clothing and laundry services are for personal use and are taxable. Anyone traveling on official business for an exempt organization must pay sales tax on taxable purchases such as parking, whether reimbursed per diem or for actual expenses incurred. A sales tax exemption does not include taxes on the purchase, rental or use of motor vehicles.[38]

D. Sales

One area of frequent confusion concerns sales by exempt organizations.[39] Specifically, many exempt organizations mistakenly assume that because *purchases* by the organization are exempt from Texas Sales Tax, *sales* by the organization also are exempt.[40] In fact, an exempt organization that sells taxable items generally is required to obtain a sales tax permit and is responsible for collection and remittance of tax on all sales of taxable items that the organization makes, unless those sales are otherwise exempt from the Texas Sales Tax.[41]

1. Sales that are "Otherwise Exempt"

There are several limited exceptions to the rules regarding sales of taxable items by exempt organizations. Also, a number of items commonly sold

[29] For a complete list of exempt organizations, see 34 TAC §§3.322(b) and (c).
[30] 34 TAC §3.322(b)(5).
[31] Tex. Tax Code Ann. §151.310(a)(2).
[32] 34 TAC §3.322(e)(1).
[33] *Id*.
[34] *Id*.
[35] 34 TAC §3.322(e)(1)(B).
[36] 34 TAC §3.322(g)(1).
[37] Texas Comptroller, Publication 196-122 "Exempt Organizations: Sales and Purchases" (November 2012), *available at* http://www.window.state.tx.us/taxinfo/taxpubs/tx96_122.pdf.
[38] *Id.*
[39] See, e.g., *T-Shirt Sales – Go Directly to Jail (and Other Consequences of Selling Things): What Nonprofits Need to Know about Texas Sales Tax Collection*, LEGAL MINUTE, Summer 2007 (*available at* http://www.texascbar.org/content/legal_library/pubs/downloads/Legal%20Minute08_07.pdf).
[40] *Id*.
[41] 34 TAC §3.322(h)(1).

for fundraisers by exempt organizations are not taxable items.

a. Meals and Food Products Sales of prepared food, candy, and soft drinks are exempt if:

- Sold by a church or at a function of a church.[42]
- Sold by a public or private elementary or secondary school, school district, bona fide student organization, booster club or other school support organization[43], or parent-teacher association if the items are sold or served during a regular school day pursuant to an agreement with the proper school authorities. This exemption includes food, soft drinks, snack items, and candy sold through vending machines.[44]
- Sold by a parent-teacher organization during a fund-raising sale if the proceeds do not go to benefit an individual.[45]
- Sold by a group associated with a private or public elementary or secondary school if the sale is part of a fund-raising drive sponsored by the organization for its exclusive use.[46]
- Sold during an event sponsored or sanctioned by an elementary or secondary school or school district at a concession stand operated by a booster club or other school support organization formed to support the school or school district, but only if the proceeds from the sale benefit the school or school district.[47]
- Sold by a member or volunteer for a nonprofit organization devoted to the exclusive purpose of education or religious or physical training of persons under 19 years of age if the sale is part of a fund-raising drive sponsored by the organization for its exclusive use.[48]
- Sold by a hospital, day care center, summer camp, or other institution licensed by the state for the care of humans if sold or served to the patients, children, students or residents of the facility. Sales to visitors or employees are taxable.[49]
- Sold by a retirement facility if the sale is to its permanent residents.[50]

b. Bake Sales

Sales tax is not due on sales of bakery items (e.g., bread, rolls, buns, biscuits, bagels, croissants, pastries, doughnuts, Danishes, cakes, pies, tarts, muffins, cookies, large pretzels, tortillas, etc.) as long as the items are sold without plates or eating utensils.[51]

c. Nontaxable Food Items

Sales tax is not due on sales of nontaxable food items. Examples of such items commonly sold through fundraisers include cookie dough, pizza kits, cheese spreads, meat sticks, jelly, salsa, fresh fruit, and mixes packaged for preparation at home.[52]

d. Magazine Subscriptions

Texas sales tax is not due on sales of subscriptions to magazines entered as periodicals-class

[42] 34 TAC §3.293(g)(1).
[43] 83(R) H.B. 697 (2013) amended Tex. Tax §151.314(d) to treat booster clubs and other school support organizations in the same manner as parent-teacher associations and other similar entities that are in place only to help students at the school.
[44] 34TAC §3.293(g)(2).
[45] 34 TAC §3.293(g)(3).
[46] 34 TAC §3.293(g)(4).
[47] Tex. Tax §151.314(d)(5), added by 83(R) H.B. 697 (2013).
[48] 34 TAC §3.293(g)(5).
[49] 34 TAC §3.293(g)(6).
[50] Tex. Tax Code Ann. §151.314(d)(1)
[51] 34 TAC §§3.293(c)(7)(A), 3.293(c)(8).
[52] *See* "School Fundraisers and Texas Sales Tax," Sales and Use Tax Bulletin (July 2009) at p.4 *available at* www.window.state.**tx**.us/**tax**info/**tax**pubs/tx94_183.pdf.

(formerly called "second-class") mail and sold for six months or more.[53] Sales tax is due on single issues and subscriptions for fewer than six months.[54]

e. Gift Certificates and Passbooks

Sales tax is not due on sales of intangibles such as gift certificates and coupon passbooks.[55] Retailers collect sales tax when certificates or coupons are redeemed for purchases of taxable items.[56]

f. Car Washes

Washing a car is not a taxable service, so Texas sales tax is not due on sales of car washes.[57]

2. Annual Banquets

All volunteer, nonprofit organizations can hold one tax-free banquet or other food sale per calendar year if all food is prepared, served and sold by members of the organization. The sale, however, cannot be professionally catered, held in a restaurant, hotel or similar place of business and cannot directly compete with a retailer required to collect tax. This exemption does not apply to the sale of alcoholic beverages.[58]

3. Auctions, Rummage Sales and Other Fund-Raisers

An exemption is provided for religious, educational, charitable, eleemosynary organizations as well as organizations exempt under I.R.C. §501(c)(3), (4), (8), (10), or (19).[59] Specifically, these organizations (and each bona fide chapter of such an organization) may have two one-day (twenty four hours) tax-free sales or auctions each calendar year.[60] During a tax-free sale or auction lasting only one day, the organization is not required to collect sales tax on the sales price of taxable items sold for $5,000 or less.[61] If the item is manufactured by the organization or donated to the organization (and not sold to the donor), the organization may sell the item during a one-day tax-free sale or auction regardless of price.[62]

The designated one-day, tax-free sale day is either the day the vendor delivers the items to the exempt organization or the day the organization delivers the items to its customers. Persons buying from surplus inventory on the designated date do not owe tax. For example, a church group selling cookbooks may accept pre-orders without collecting tax if the day the cookbooks will be delivered to customers is designated as one of the group's tax-free fundraisers. Surplus cookbooks sold during the same day also qualify for the exemption. Surplus cookbooks sold on other days are taxable unless sold at the group's other tax-free fundraiser.[63]

Organizations that hold a joint one-day tax-free sale or auction are each considered to have held one tax-free sale or auction during the calendar year; however, each such organization may hold one additional tax-free sale or auction during that calendar year.[64]

If an exempt organization is purchasing taxable items for resale during its designated tax-free sale days, and it holds a sales tax permit, the organization may either give the retailer a resale certificate, Form 01-339 (front), or an exemption certificate, Form 01-339 (back), to purchase the items tax-free. A non-permitted exempt organization, however, may purchase items for resale tax-free by issuing an exemption certificate to the vendor for items sold during its two one-day, tax-free sales.[65]

4. Higher Education Student Organizations

College or university student organizations affiliated with an institution of higher education can hold a one-day, tax-free sale each month. The organization must have a primary purpose other than engaging in business or performing an activity designed to make a profit, and the purpose of the sale must be to raise funds for the organization. This exemption does

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[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.* The tax is based on the item's actual retail selling price, less any cash discount given at the time of sale (e.g., a deduction for a coupon).
[57] *Id.*
[58] The annual banquet exception is not codified in any statute or rule. It is a matter of administrative practice and frequently is cited in Comptroller publications. *See, e.g.,* Texas Comptroller, Publication 196-122 "Exempt Organizations: Sales and Purchases", *supra note 37*; Comptroller's Letter 8812L0922G06; http://fundraisetaxlaw.org/tx.html.
[59] Tex. Tax Code Ann. §151.310.
[60] Tex. Tax Code Ann. §151.310(c).
[61] *Id*.
[62] *Id*.
[63] Texas Comptroller, Publication 196-122 "Exempt Organizations: Sales and Purchases" (November 2012), *supra* note 37.
[64] Tex. Tax Code Ann. §151.310(d).
[65] Texas Comptroller, Publication 196-122 "Exempt Organizations: Sales and Purchases" (November 2012), *supra* note 37.

not apply to items sold for more than $5,000, unless the item is manufactured by the organization or the item is donated to the organization and not sold back to the donor.[66]

5. Amusement Services

Sales tax is not due on sales of amusement services by a nonprofit corporation (other than an I.R.C. §501(c)(7) organization) if the proceeds do not go to the benefit of an individual, except as a part of the services of a purely public charity.[67]

Amusement services include live or recorded performances,[68] circuses,[69] ice skating shows,[70] motion pictures,[71] musical concerts, [72]exhibitions or displays,[73] antique shows,[74] arts and crafts shows,[75] auto shows,[76] zoos, [77]rodeos,[78] wrestling,[79] boxing,[80] bowling games,[81] golf driving ranges,[82] health clubs (admissions and memberships),[83] chartered boat excursions,[84] pool games,[85] swimming pools, [86]rides for pleasure,[87] and parties that radio stations, etc. sponsor (ticket price includes meal, set-ups, entertainment, and party favors).[88]

For an event to qualify for exemption, the organization must distinguish itself as the sole provider in advertising (for example, billboards, radio, television and other media promoting the event), as well as on the face of the physical tickets. Tickets should reflect that the exempt organization is the provider, and that the event is exempt from Texas sales and use tax. A nonprofit organization is allowed to hire a for-profit entity to supply expertise required to produce an event as long as the for-profit entity is not also considered a provider of the amusement service.[89]

IV. TEXAS HOTEL OCCUPANCY TAX

A. Organizations Exempt from Tax

Charitable, educational, and religious organizations that have received an exemption letter from the Texas Comptroller may claim exemption from the 6 percent state hotel occupancy tax.[90] Local taxes must be paid.

As stated above in connection with margin tax, in order for an organization to be exempt from hotel occupancy tax, it must obtain its exemption on the basis of a specific Texas statute, not on the basis of its federal exempt status.[91] In simple terms, restated here,

For purposes of hotel tax exemption:

- Religious organizations are nonprofit churches and their guiding or governing bodies. Missionary organizations, Bible study groups or churches that are made up of only family members do not qualify.
- Charitable organizations are nonprofit organizations that devote all or substantially all of their activities to providing food, clothing, medicine, medical treatment, shelter or psychological counseling directly to indigent and similar individuals for little or no charge. Not included are fraternal organizations and social, professional and business groups.
- Educational organizations include independent school districts, public or nonprofit private elementary and secondary schools, and Texas institutions of higher education.[92] A public or private institution of higher education is organized and operated

[66] *Id.*
[67] Tex. Tax Code Ann. §151.3101(3).
[68] 34 TAC §3.298(a)(1)(A).
[69] 34 TAC §3.298(a)(1)(A)(ii).
[70] 34 TAC §3.298(a)(1)(A)(iii).
[71] 34 TAC §3.298(a)(1)(A) (iv).
[72] 34 TAC §3.298(a)(1)(A)(v).
[73] 34 §3.298(a)(1)(B)(2009).
[74] 34 TAC §3.298(a)(1)(B)(ii).
[75] 34 TAC §3.298(a)(1)(B)(iv).
[76] 34 TAC §3.298(a)(1)(B)(v).
[77] 34 TAC §3.298(a)(1)(B)(vii).
[78] 34 TAC §3.298(a)(1)(C)(v).
[79] 34 TAC §3.298(a)(1)(C)(vii).
[80] *Id*.
[81] 34 TAC §3.298(a)(1)(D)(ii).
[82] 34 TAC §3.298(a)(1)(D)(vii).
[83] 34 TAC §3.298(a)(1)(D)(viii).
[84] 34 TAC §3.298(a)(1)(D)(x).
[85] 34 TAC §3.298(a)(1)(D)(xi).
[86] 34 TAC §3.298(a)(1)(D)(xiv).
[87] 34 TAC §3.298(a)(1)(E)(iv).
[88] 34 §3.298(a)(1)(E)(iii).
[89] Texas Comptroller, Publication 196-122 "Exempt Organizations: Sales and Purchases" (November 2012), *supra* note 37.
[90] Tex. Tax. §156.102.
[91] *See* 34 TAC §3.161(a) for definitions of the various exemption categories.
[92] Texas Comptroller 200311950L (11/01/2003).

exclusively for an educational purpose only if it is defined as a Texas institution of higher education or as a Texas private or independent institution of higher education under any subdivision of Section 61.003 of the Texas Education Code.[93]

Texas does not recognize exemption for hotel occupancy tax on the basis of federal exemption.

B. When The Exemption Applies

Religious, charitable, and educational organizations and their employees, including college and university personnel, traveling on official business of the organization are exempt from payment of hotel occupancy tax.[94]

C. Claiming The Exemption

If the exemption applies, the organization or individual claiming the exemption must present an exemption certificate to the hotel.[95] The individual also must provide:

- a letter of hotel occupancy tax exemption issued by the Comptroller; or
- verification that the organization is on the Comptroller's list of entities that have been provided a letter of exemption (such as a printed copy of the Comptroller's website listing the organization as exempt for hotel tax).[96]
  Caution: The manner of payment by an *employee* of an exempt organization does not affect the exemption. To claim an exemption, a *nonemployee* traveling on behalf of an exempt organization must pay the hotel directly with the organization's funds, by organization check, organization credit card, or direct billing to the organization by the hotel.[97]

V. MOTOR VEHICLE SALES, RENTAL, AND USE TAX

- Like hotel occupancy tax exemptions, motor vehicle sales, rental, and use tax ("motor vehicle tax") exemptions are extremely limited. The exemption for motor vehicle tax is available at the time of purchase on the Application for Certificate of Title. The exemption is available at the time of rental by including a Motor Vehicle Rental Exemption Certificate with the rental contract. The certificate must be signed by an authorized representative of the group or organization that is renting the vehicle.[98]

A. Sales, Leases, and Use of Motor Vehicles

1. Motor Vehicles Driven By or Used to Transport Orthopedically Disabled Persons

Motor vehicle tax is not imposed on the sale or use of a motor vehicle that (1) has been or will be modified before the second anniversary of the date of purchase for operations by, or for the transportation of, an orthopedically disabled person; and (2) is driven (primarily) by or used (primarily) for the transportation of an orthopedically disabled person.[99] A vehicle is considered to meet the use requirement if it is driven by, or used for the transportation of, an orthopedically disabled person at least 80% of its operating time.[100]

A corporation or association may purchase a vehicle under this exemption if the requirements of the statute and rule are met.[101]

2. Fire Departments/EMS Providers

Motor vehicle sales tax does not apply to the purchase, rental, or use of a fire truck, emergency medical services vehicle, or other motor vehicles used exclusively for fire-fighting purposes or emergency medical services when purchased by (1) a volunteer fire department, (2) a nonprofit emergency medical service provider that is exempt under I.R.C. §501(c)(3), or (3) an emergency medical service provider to which Section 502.204 of the Texas Transportation Code applies.[102]

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[93] Tex. Tax. §156.102(b)(2).
[94] 34 TAC §3.161(b)(1).
[95] 34 TAC §3.161(b)(5)
[96] 34 TAC §3.161(c)(2)(D).
[97] 34 TAC §3.161(c)(2)(F).
[98] Texas Comptroller, Publication 196-122 "Exempt Organizations: Sales and Purchases" (November 2012), *supra* note 37.
[99] Tex. Tax. §152.086. Regulations under this section include "primarily".
[100] 34 TAC §3.84(a)(5).
[101] 34 TAC §3.84(c).
[102] Tex. Tax. §152.087.

3. Motor Vehicles Used for Religious Purposes

Motor vehicle sales tax is not due on sale, rental, or use of a motor vehicle that (1) is designed to carry more than six passengers, (2) is sold to or used by a church or religious society, and (3) that is used primarily for the purpose of providing transportation to or from religious services or meetings.[103] A vehicle is "primarily" used for permitted purposes if it is used at least 80% of the time for such purposes.[104]

The term "church or religious society" refers to a regularly organized group of people associating for the sole purpose of holding, conducting, and sponsoring, according to the rites of the sect, religious worship. An organization supporting and encouraging religion as an incidental purpose, or an organization with the general purpose of furthering religious work or instilling its membership with a religious understanding is not sufficient to qualify as a church or religious society.[105]

The exemption does not apply to a vehicle registered as a passenger vehicle, the primary use of which is for the personal or official needs or duties of a minister.

4. Motor Vehicles Used By Licensed Child Care Facilities

Motor vehicle tax does not apply to the sale of a motor vehicle that is (1) purchased, used, or rented by a qualified residential child-care facility; and (2) intended for use primarily in transporting the children residing in the facility under a state license.[106] The facility must provide 24-hour residential care in a single residential group.[107]

B. Gifts of Motor Vehicles

Ordinarily, motor vehicle tax is imposed on the receipt of a gift of a motor vehicle. [108] The transfer of a motor vehicle for no consideration results in the imposition of tax based—essentially—on the vehicle's standard presumptive value. However, a vehicle that is donated to or given by an I.R.C. §501(c)(3) organization is subject only to a $10 gift tax.[109]

By rule, the $10 gift tax is imposed on the recipient of an interest in a motor vehicle from or to a nonprofit organization that:

- Obtains a determination letter or group exemption ruling letter from the Internal Revenue Service that states that the organization is exempt from tax under I.R.C §501(c)(3); and
- Uses the motor vehicle exclusively for the purposes for which the organization was established.[110]

Note that the statute defines "gift" (in relevant part) only to the gratuitous transfers of a motor vehicle to a qualifying nonprofit organization. The regulations expand the definition to include a gratuitous transfer from a nonprofit organization, for the purposes of the organization.

To document a gift, both the donor and the recipient must complete a joint notarized Affidavit of Motor Vehicle Gift Transfer (Form 14-317) describing the transaction and the relationship between the parties. The affidavit should be provided to the county tax assessor-collector, along with the Application for Certificate of Title.[111]

C. Motor Vehicles as Prizes

An interest in a motor vehicle that is transferred to the winner of a contest or drawing, regardless of how the contest or drawing is held, is subject to motor vehicle tax.[112] However, the way that the transaction is structured can dramatically affect the tax liability.

1. Contest Sponsor Pays Consideration for Vehicle

If the vehicle is purchased by the contest sponsor and transferred directly from the seller of the vehicle to the contest winner, it is subject to tax based on the total consideration paid for the vehicle. The tax is the liability of the contest sponsor and is due or payable before the vehicle can be titled or registered.[113]

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[103] Tex. Tax. §152.088; 34 TAC §3.82.
[104] 34 TAC §3.82(c).
[105] 34 TAC §3.82(b).
[106] Tex. Tax §152.093.
[107] Texas Comptroller, Publication 196-122 "Exempt Organizations: Sales and Purchases" (November 2012), *supra* note 37.
[108] Tex. Tax. §152.025.
[109] Tex. Tax §152.025; 34 TAC §3.80(b).
[110] 34 TAC §3.80(b)(4).
[111] 34 TAC §3.80(f); Texas Comptroller, Publication 196-122 "Exempt Organizations: Sales and Purchases" (November 2012), *supra* note 37.
[112] 34 TAC §3.80(e).
[113] 34 TAC §3.80(e)(1).

If the vehicle is transferred directly from the seller to the contest sponsor for consideration, and the sponsor subsequently transfers the vehicle to the contest winner, the sponsor owes tax on the total consideration paid to the seller, and the winner owes tax on the total presumptive value (unless the transfer qualifies as a gift).[114]

Note, pursuant to the Charitable Raffle Enabling Act, the value of a prize offered or awarded at a raffle that is purchased by an organization or for which the organization provides any consideration may not exceed $50,000.[115]

2. Contest Sponsor Does Not Pay Consideration for Vehicle

If the vehicle is transferred directly from the owner of the vehicle to a contest sponsor that qualifies as a nonprofit corporation pursuant to Rule 3.380(b)(4) for no consideration, and the sponsor subsequently transfers the vehicle to the contest winner, the sponsor and the winner both owe the $10 gift tax.[116]

VI. TEXAS PROPERTY TAX

A. In General

Unlike margin tax and sales tax exemption applications, property tax exemption applications are filed with the local appraisal district, not with the Comptroller.[117] The general deadline for filing an exemption application is before May 1.[118] Charitable organizations improving property for low-income housing and community housing development associations must file the application for exemption within 30 days of acquiring the property.[119] If a property owner fails to file a required application on time, the owner usually forfeits the right to the exemption unless late application provisions exist.[120]

Some exemptions require the property owner to file an application only one time (although most of these allow the chief appraiser to request a new application to verify that the exemption requirements continue to be met), and others require the owner to file an application annually.

The various exemptions that might be available to nonprofit corporations are set forth in the Texas Property Code and are summarized in the Comptroller's Publication, "Texas Property Tax Exemptions: Complete and Partial Property Tax Code Exemptions Available to Property Owners Who Qualify" (February 2018).[121] They also have been summarized in other State Bar articles.[122]

B. A Caution, and a Potential Planning Technique

Practitioners are cautioned that—the number of different exemption provisions notwithstanding—many of the exemptions are more narrowly-tailored than their titles suggest, and an organization that is squarely within the requirements of I.R.C. §501(c)(3) or sales and margin tax exemption nevertheless might not qualify for property tax exemption. In particular, when considering whether to restructure a nonprofit enterprise for liability protection or other purposes, a practitioner should carefully consider whether a post-restructuring entity that owns property will qualify for property tax exemption. In particular, the practice of separating ownership of property from "risky" operations may result in loss of property tax exemption for the non-operating entity.

In terms of structuring options, the author has had success obtaining property tax exemption for property owned by a single-member LLC that is disregarded as an entity separate from its parent for federal income tax purposes where the parent qualifies as a charitable organization under Tex. Tax §11.18.

The support for this position is found in Texas Attorney General in Opinion No. GA-1092. In particular, the charitable tax exemption under Tex. Tax §11.18 stems from article VIII, section 2 of the Texas Constitution, which provides that "the legislature, may, by general laws, exempt from taxation…institutions engaged primarily in charitable functions." The Texas legislature enacted Tex. Tax §11.18 in implementation of this constitutional provision.[123]

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[114] 34 TAC §3.80(e)(2).
[115] Tex. Occ. §2002.056(b).
[116] 34 TAC §3.80(e)(3).
[117] Tex. Tax §11.45.
[118] Tex. Tax §11.43(d).
[119] Tex. Tax §11.436.
[120] Tex. Tax §§ 11.43(d), 11.431, 11.433, 11.435, 11.438, 11.439, and 11.4391.
[121] Available at https://comptroller.texas.gov/taxes/property-tax/docs/96-1740.pdf.
[122] *See, e.g.,* John Brusniak, Jr., "Qualifying Your Client's Property for Property Tax Exemption in Texas," State Bar of Texas 11th Annual Governance of Nonprofit Organizations, August 22-23, 2013 (Chapter 14).
[123] *See* Tex. Tax §11.18; *see also N. Alamo Water Supply Corp. v. Willacy Cnty. Appraisal Dist*., 804 S.W.2d 894, 895

Both Tex. Tax §11.18 and article VIII, section 2 allow tax exemption only for property that a charitable organization owns and uses. On multiple occasions, the Texas Supreme Court has held that an equitable ownership interest (rather than a legal ownership interest) is sufficient to support an entity's claim of property ownership for purposes of a tax exemption under Tex. Tax §11.182.[124] Texas courts of appeals also have recognized the sufficiency of equitable ownership in the context of a tax exemption for public property under Tex. Tax. §11.11.[125]

Like Tex. Tax §11.18, Tex. Tax §11.182 and Tex. Tax §11.11 were adopted under article VIII, section 2.[126] Because Tex. Tax §11.18 was adopted under the same constitutional provision under which Tex. Tax §11.182 and Tex. Tax §11.11 were adopted, it should be interpreted to include equitable ownership on the same basis that the other two provisions are. Further, in *Comerica Acceptance Corp. v. Dallas Cent. Appraisal Dist.*,[127] the court noted that the Tax Code does not define "owner" and used a definition of "owner" that incorporated equitable title. Based on this authority, the Texas Attorney General has concluded that "it is likely that a court would determine the principles of equitable ownership are applicable to an entity seeking a charitable tax exemption under [Tex. Tax §]11.18."

Equitable title is "the present right to [compel] legal title."[128] Equitable title "is a current 'right in the party to whom it belongs to have legal title transferred to him.'"[129] If an organization that qualifies as a charitable organization under Tex. Tax §11.18 is the sole member and manager of an property-holding LLC—such that it can cause a dissolution of the LLC such that all assets are transferred to it—it holds equitable title to the property of the LLC. Because, according to the Texas Attorney General, "it is likely that a court would determine that the principles of equitable ownership are applicable to an entity seeking a charitable tax exemption under [Tex. Tax §]11.18," the property should be exempt from property tax.

VII. CONCLUSION

By understanding the various state tax regimes to which their clients might be subject—and the exemption requirements for each—practitioners can ensure that their clients comply with applicable law and can make recommendations about how transactions or entities can be structured to improve tax efficiency.

(Tex. 1991) (noting that Tex. Tax §11.18 was enacted under article VIII, section 2).

[124] *See e.g., Galveston Cent. Appraisal Dist. v. TRQ Captain's Landing*, 423 S.W.3d 374 (Tex. 2014), *AHF-Arbors at Huntsville I, LLC v. Walker Cnty Appraisal Dist*., 410 S.W. 3d 831 (Tex. 2012).

[125] *See, e.g., Travis Cent. Appraisal Dist. v. Signature Flight Support Corp*., 140 S.W.3d 833, 837 (Tex. App.—Austin, 2004, no pet.); *Sweetwater Indep. Sch. Dist. v. ReCOR, Inc*., 955 S.W.2d 703, 704 (Tex. App.—Eastland 1997, pet. denied).

[126] *See Harris Cnty. Appraisal Dist. v. Primrose Houston 7 Housing, L.P*., 238 S.W.3d 782, 785 (Tex. App.—Houston [1st Dist.] 2007, pet. denied) (noting that Tex. Tax §11.182 is enabling legislation for article VIII, section 2), *Tex. Dep't of Corrs. v. Anderson Cnty. Appraisal Dist*., 834 S.W.2d 130, 131 (Tex. App.—Tyler 1992, writ denied) (noting legislature's adoption of Tex. Tax §11.11 under article VIII, section 2).

[127] .52 S.W.3d 495, 497 (Tex. App.—Dallas 2001, pet. denied).

[128] *TRQ Captain's Landing, L.P. v. Galveston Cent. Appraisal Dist*., 212, S.W.3d 726, 732 (Tex. App.—Houston [1st Dist.] 2006) aff'd, 423 S.W.3d 374 (Tex. 2014), cited in Opinion No. GA-1092 at 3.

[129] Opinion No. GA-1092 at 3, citing *Tanner v. Imle*, 253 S.W. 655, 668 (Tex. Civ. App.—San Antonio 1923, writ dism'd).

BEST PRACTICES FOR NONPROFIT BOARD MEETINGS

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Editor, Family Foundation Advisor

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I. INTRODUCTION

Under Texas law, by default, a nonprofit corporation's affairs are managed by a board of directors, which may be referred to by any name appropriate to the customs, usages, or tenants of the corporation. As a body, a board of directors has significant power, but an individual director acting alone has very little. It is through their participation as members of board—generally at board meetings—that individual directors influence the actions of a nonprofit corporation.

At their best, nonprofit boards of directors focus on three areas:

- Direction—steering the organization towards its mission;
- Oversight—monitoring the organization's activities, health, and ethical behavior; and
- Resources—ensuring that the organization is well-equipped to fulfill its mission with adequate finances, capable staff, and solid reputation.

Board meetings are the forum through which governance decisions are made and board business is conducted, and an organization's effectiveness at conducting board meetings contributes to the organization's effectiveness overall. And, well-run board meetings provide a mechanism by which board members fulfill their duties of care, loyalty, and obedience to the corporation.

This article discusses various aspects of board meetings and offers suggestions for making meetings more productive. Many of the practices described automatically are permitted under the Texas Business Organizations Code ("BOC"). As a practical matter, however, directors and staff will look to an organization's Bylaws—not the BOC—to determine whether a particular practice is permissible. As a result, efficiency may be enhanced if those permissive provisions of the BOC are incorporated into the Bylaws, even though they apply automatically in the absence of a Bylaw provision to the contrary. And, certain practices (such as taking action by majority vote over email) must be permitted by the Certificate of Formation or Bylaws in order to be lawful. A review of the Bylaws, oriented towards meeting procedures, is helpful to ensure that the Bylaws are effective for facilitating good board meetings and efficient board action.

II. NOTICE REQUIREMENTS

Regular meetings of the board of directors may be held with or without notice as prescribed in the nonprofit corporation's Bylaws. For example, an organization's Bylaws might provide that meetings will be held at 7 p.m. on the second Thursday of each month at the organization's headquarters. As a practical matter, to encourage attendance at to facilitate rescheduling without amending the Bylaws, an organization should make a practice of providing notice for all meetings of the board of directors.

Special meetings may be held with notice as prescribed by the Bylaws. The BOC provides that notice may be delivered personally or by mail, facsimile, or e-mail. However, an organization that has not had its Bylaws reviewed or updated recently may find that the Bylaws do not refer to e-mail notice, and the BOC's notice provisions are "subject to the governing documents". Accordingly, a director seeking to challenge the validity of a meeting might point to Bylaws authorizing notice in person, by mail, or by facsimile to argue that email notice was not sufficient. To avoid a dispute regarding whether a meeting was lawfully convened, the Bylaws should refer to all permissible forms of notice that the organization intends to use.

Unless required by the Bylaws, the business to be transacted at, or the purpose of, a regular or special meeting of the board of directors is not required to be specified in the notice or waiver of notice of the meeting. However, the notice must provide:

- The date and time of the meeting; and
- If the meeting is not held solely by remote communications technology, the location of the meeting, or
- If the meeting is held solely or in part by remote communication technology, the form of communication system to be used and the means of accessing the communications system.

A director's attendance at a meeting constitutes a waiver of notice unless the director attends the meeting for the express purpose of objecting to the transaction of any business on the ground that the meeting was not lawfully called or convened.

III. QUORUM

In simple terms, a quorum is the minimum number of voting board members who must be present at a meeting in order for business to be conducted. The existence of a quorum prevents action from being taken by a small or non-representative group of directors.

Under Texas law, a quorum for the transaction of business by the board of directors is the lesser of:

1) The majority of the number of directors set by the corporation's Bylaws, or in the absence of a Bylaw setting the number of directors, a majority of the number of directors stated in the corporation's Certificate of Formation; or

2) Any number, not less than three, set as a quorum by the Certificate of Formation or Bylaws.

A director present by proxy at a meeting may not be counted towards a quorum.

The larger the number at which quorum is set, the more representative of the entire board a convened group of directors will be. Setting a low quorum and permitting action by a simple majority of those directors present may result in decisions being made by too few—or a non-representative group of—directors.

Example: When it was founded, the hypothetical organization, CharityTogether, had five directors. The directors adopted Bylaws that provide that any three members of the Board of Directors constitute a quorum and that directors may act by majority. Over time, the board has grown and now comprises fifteen individuals. Under CharityTogether's Bylaws, action can be taken by only two of fifteen directors.

Challenges also arise if quorum is set too high: the more directors required to make quorum, the less likely enough individuals will be present in person so that business can be conducted.

In the absence of a quorum, the only options available are to take measures to obtain a quorum, to fix the time to which to adjourn and then adjourn, or to take a recess. Even if everyone present agrees to continue with the meeting, the prohibition on transaction business without a quorum cannot be waived. According to BoardSource, the mission of which is "to inspire and support excellence in nonprofit governance and board and staff leadership,"

Under very special circumstances, if an important opportunity would be missed, members might consider taking a risk and act in an emergency, with the hope that their decision will be ratified later during a meeting when quorum is present.

One way to balance between the benefits and challenges of small and large quorum requirements is to set a more manageable quorum (such as a majority of the directors set by the Bylaws) for routine matters and a higher quorum requirement (such as two-thirds of the directors set by the Bylaws) for more important meetings (such as the annual meeting) or issues (such as amendments to the Bylaws or Certificate of Formation).

Robert's Rules of Order suggests that "the Bylaws should provide for a quorum as large as can be depended upon for being present at all meetings when the weather is not exceptionally bad."

If an organization struggles to make quorum, the following questions might help identify the reasons:

- Are all of the meetings necessary, or could business be deferred to less frequent meetings, or handled by an executive committee or written consent?
- Would attendance improve if directors could participate by conference call?
- Are the meetings boring, badly prepared, or poorly run?
- Are directors aware of the requirement to attend meetings and notified of scheduled meetings well in advance?
- Are the meetings too long, held at an inconvenient time or place, or not scheduled far enough in advance?
- Do the Bylaws contain an automatic removal provision for directors who miss a certain number of meetings?

IV. PROXIES

If authorized by the Certificate of Formation or Bylaws, a director of a nonprofit corporation may vote by written proxy. A proxy expires three months after it is executed and is revocable unless otherwise provided by the proxy or made irrevocable by law.

Despite the fact that the BOC permits a nonprofit corporation to allow proxy voting, this author does not make a practice of including proxy provisions in nonprofit Bylaws. Each director has fiduciary duties that cannot be delegated (including to another director who holds a proxy), and the discussion at a board meeting might have influenced an individual's vote had he or she been there to vote in person. In such case, a

proxy vote might not reflect the principal's position had he or she attended the meeting in person.

V. MEETING BY REMOTE TECHNOLOGY

The BOC permits directors to meet by remote electronic communication (such as conference call, videoconference, or the Internet) provided that

1) Each person entitled to participate in the meeting consents to the meeting being held by means of that system; and
2) The system provides access to the meeting in a manner or using a method by which each person participating in the meeting can communicate concurrently with each other participant.

If voting is to take place at the meeting, the organization must:

1) Implement reasonable measures to verify that every person voting at the meeting by means of remote communications is sufficiently identified; and
2) Keep a record of any vote or other action taken.

The BOC does not preclude directors present by remote communication from counting towards a quorum. Thus, by investing in remote communication technology, an organization can better ensure that quorum is met and may be able to adopt a higher quorum requirement, resulting in more people contributing to board deliberation and decision-making.

VI. ACTION BY WRITTEN CONSENT

In this author's experience, the concept of action by written consent most often arises when boards of directors seek to allow "e-mail voting." E-mail voting is a form of written consent. For purposes of the BOC, the terms "writing" and "written" includes stored or transmitted electronic data, electronic transmissions, and reproductions of writings. A "signature" is any symbol executed by a person with present intention to authenticate a writing. Unless the context requires otherwise, the term includes a digital signature, an electronic signature, and a facsimile of a signature.

A. Unanimous Written Consent—Automatically Permitted

Unless the Certificate of Formation or Bylaws provide otherwise, the board of directors can take action by unanimous written consent. Specifically, "the members of the governing authority may take action without holding a meeting, providing notice, or taking a vote if each person entitled to vote on the action signs a written consent stating the action taken." A unanimous written consent has the same effect as a unanimous vote at a meeting.

B. Less-Than-Unanimous Written Consent—Must Be Permitted in Governing Documents

Unlike with unanimous written consent—which the BOC automatically permits—in order for directors to be able take action by less-than-unanimous written consent (for example, by majority or super-majority), the Certificate of Formation or Bylaws must explicitly permit it.

The Certificate of Formation or Bylaws of a nonprofit corporation may provide that an action required or permitted to be taken at a board meeting may be taken without a meeting if a written consent, stating the action to be taken, is signed by the number of directors needed to take that action at a meeting at which all of the directors are present and voting. The consent must state the date of each director's signature, and prompt notice of the directors' action by less-than-unanimous written consent must be given to each director who did not consent in writing to the action. The BOC does not define "prompt." Accordingly, it would be good practice for the provision in the governing documents that permits action by less-than-unanimous-written consent to provide a specific timeframe (such as one week) to cue officers, directors, and/or staff to the notice requirement and the precise deadline.

Though convenient, routine use of e-mail voting (or other action by written consent) is not a substitute for regular board meetings, because it does not give board members the same opportunity to share their points of view or the focused time to deliberate that meetings do. For this reason, it is best reserved for relatively routine matters or for matters that have been fully discussed at prior board meetings.

VII. CONSENT AGENDA

The consent agenda model allows a board to bundle together minutes, committee reports, routine ratifications, and other routine business such as

approval of banking relations into one item for approval. During the meeting, no questions or comments on consent agenda items are allowed, and items are approved either without a vote if there is no objection, or by formal vote. Note that as a matter of risk management, the Treasurer's report should not be put in a consent agenda, because the board does not want to be held accountable for unaudited—and potentially inaccurate—numbers. Single items can be removed from the consent agenda and considered separately, even if only one director wishes to do so. Removal must be requested ahead of the meeting.

The consent agenda model allows most of the board's tactical work to be done in committees and the board to use its meeting time for strategic or generative conversation, or for board education or development. The model helps drive a board toward a strategic (rather than tactical or operational) orientation, because it focuses the board's time and attention on the future, rather than on events that already have occurred or decisions that already have been made.

In order to follow a consent agenda model, a board must ensure that:

- Committees distribute reports or minutes well in advance of board meetings so that directors have a chance to read and absorb them.
- Directors actually take the time to read the material in advance.
- All board members understand which items can be placed on a consent agenda and the process for taking an item from the consent agenda and onto the regular agenda for discussion.

VIII. STAFF ATTENDANCE

In this author's experience, the Executive Director/Chief Executive Officer of an organization (regardless of title) attends board meetings. This practice is extremely beneficial, as it allows a free exchange of information between the strategic board of directors level and the operational or tactical staff level. In this author's opinion, it is very good practice to have other staff members attend board meetings, including lower-level staff on a rotating basis.

From a practical perspective, staff participation at meetings helps both board members and staff to understand the other's perspective and the challenges. Staff members can provide the detail that informs board strategy. From an engagement perspective, board members can be energized and inspired by the mission-serving work different staff members perform, and staff members can be motivated and feel appreciated by the opportunity to join a board meeting. Most importantly, from a risk-management perspective, inviting key staff members to attend and present at board meetings prevents all information on which the board relies from being funneled through a single chief executive

IX. EXECUTIVE SESSION

The BOC does not specifically provide for closed meetings or Executive Sessions of nonprofit corporations. Subchapter D of the Texas Open Meetings Act provides certain narrow exceptions to the requirement that meetings of a governmental body be open to the public. The Open Meetings Act does not apply to nonprofit corporations that are not "governmental bodies." Nevertheless, in this author's experience, nonprofit corporation boards of directors do undertake Executive Sessions from time to time.

Executive Sessions provide the board a confidential forum to discuss matters without staff or any other third parties (other than the organization's legal counsel) present. They are useful when discussing:

- The annual audit;
- The Executive Director/Chief Executive Officer's annual performance review or compensation;
- Legal issues; and
- Board practices, behavior, or performance issues.

An Executive Director/ Chief Executive Officer may have concerns about what is discussed during an Executive Session. To help encourage what should be a relationship of trust between the board and staff, whenever possible, directors should share the agenda for the Executive Session with the Executive Director/ Chief Executive Officer and, after the session, update him or her with the nature of the discussions.

Executive Sessions should not be overused. Just because a conversation will be frank or uncomfortable does not mean that it cannot be had with the Executive Director/ Chief Executive Officer in the room. Boards and executive staff should be able to handle candor. At the same time, by allowing time for Executive Session on every meeting agenda (or perhaps quarterly, or semi-annually), a board gives itself the opportunity to have confidential discussions as part of its routine, thereby minimizing undue distress to the Executive Director/ Chief Executive Officer.

X. EXECUTIVE COMMITTEE

Some organizations have a regular need for board-level action or oversight. These needs may be more frequent than regular (even monthly) board meetings can accommodate and more substantive than e-mail voting or other action by written consent reasonably should be used to address. The BOC allows a board of directors to designate one or more "management committees" to exercise the authority of the board, provided that the Certificate of Formation or Bylaws authorizes it to do so. A committee that acts in place of the full board commonly is referred to as the "Executive Committee." An Executive Committee must be designated by a resolution adopted by a majority of the board of directors and has the authority of the board to the extent provided by the resolution, the Certificate of Formation, or the Bylaws. An Executive Committee must consist of at least two persons, the majority of whom are directors (unless the organization is a religious institution). As a practical matter, Executive Committees typically include the board officers such as the President, Vice-President, Secretary, Treasurer , and—perhaps—the Immediate Past President.

It is important that all directors understand that the use of an Executive Committee does not operate to relieve the board of directors or any individual director from any responsibilities imposed by law. Further, an Executive Committee member who is not a director has the same responsibility with respect to the committee as a committee member who is a director. Thus, while an Executive Committee facilitates board-level attention between meetings, all directors—including those not on the Executive Committee—should remain engaged with the governance process. Good practices include:

- Clearly identifying the limits of the Executive Committee's authority (for example, preventing the committee from amending governing documents or exercising authority granted to other committees);
- Requiring the Executive Committee to report actions taken to the full board of directors at the next board meeting;
- Making sure that board members who do not serve on the Executive Committee participate in other committees; and
- Regularly rotating board officers so that a variety of individuals serve on the Executive Committee across time.

When an organization uses and Executive Committee, the other board members should be informed of any actions taken by the Executive Committee since the last board meeting as promptly as practical.

XI. EMERGENCY GOVERNANCE

The BOC permits a nonprofit corporation to adopt emergency governance provisions. An emergency exists if a majority of the governing persons cannot readily participate in a meeting because of the occurrence of a catastrophic event. Except as prohibited by the corporation's governing documents, the board of directors may adopt provisions in the governing documents regarding the management of the corporation during an emergency, including provisions:

1) Prescribing procedures for calling a meeting of the governing persons;
2) Establishing minimum requirements for participation at the meeting of the governing persons; and
3) Designating additional or substitute governing persons.

The emergency provisions must be adopted in accordance with the requirements for governing documents and the applicable provisions of the BOC.

The emergency provisions take effect only in the event of an emergency and are no longer effective after the emergency ends. Any provisions of the governing documents that are consistent with the emergency provisions remain in effect during an emergency.

An action taken in good faith in accordance with the emergency provisions is binding on the corporation and may not be used to impose liability on a managerial official (such as an officer or director), employee, or agent of the corporation.

XII. MINUTES

A nonprofit corporation is required to maintain minutes of the proceedings of the board of directors and any committees. Minutes may be kept in written paper form or another form capable of being converted into written paper form within a reasonable time (i.e., electronic Word or pdf documents that can be printed out). A member of the board of directors may examine the minutes for a purpose reasonably related to the director's service as a director. A member of the organization may examine the minutes to the extent

provided by the governing documents. Regardless of the provisions of the governing documents, a member of a nonprofit corporation also may examine the minutes on written demand stating the purpose of the demand at any reasonable time.

In addition to facilitating compliance with the BOC, meeting minutes serve a number of important functions. The basic elements of good minutes include:

- Name of the organization
- Date and time of meeting
- Board members in attendance, excused, or absent and that quorum was established
- Names and titles/roles of any others present at the meeting
- Motions made and by whom
- Brief account of any debate
- Voting results
- Names of abstainers and dissenters
- Reports and documents introduced
- Future action steps
- Time meeting ended
- Signature of Secretary and President (or Chair)

If an Executive Session is held as part of a board meeting, the minutes should reflect that fact and should report on the topic of the discussion (without specifics). Confidential-to-the-board minutes or other notes can contain more detail.

Different organizations will have different perspectives about exactly how much detail to include in the minutes. Some organizations err on the side of a more exhaustive or complete historical record. Others prefer the minutes to be more summary and uncluttered. A good rule of thumb is that someone looking at the minutes should be able to understand what decisions were made and the reasons why. The minutes should not be a verbatim transcript of the discussion, but they should be a record of decisions made and actions taken. Where there is debate or discussion, the major points for or against a decision should be included. In order for directors to have meaningful discussion without being concerned about individual liability, names or direct quotations should not be recorded.

Regardless of the level of detail ordinarily used in an organization's minutes, certain details should be included in special circumstances. One situation is when a director dissents to the distribution of assets other than to pay creditors. Under the BOC, a director who is present at a meeting at which a distribution of assets was approved is presumed to have assented to that action (and thus may have personal liability) unless certain requirements are met, including that the director's dissent was entered in the minutes of the meeting. More broadly, any individual board member who is concerned about personal liability arising from any board action should ensure that his or her dissent to the action is reflected in the meeting minutes.

Another situation involves potential excess benefit transactions. In order to avail themselves of the rebuttable presumption that a transaction was not an excess benefit transaction, board members should ensure that the documentation required by Treas. Reg. §53.4958-6 is included in the minutes and, if the transaction relates to compensation, that the minutes reflect all of the economic benefits flowing to a disqualified person that are intended to be treated as part of "reasonable" compensation.

XIII. CONCLUSION

Well-run board meetings provide a forum in which directors of nonprofit corporations can carry out their fiduciary duties and help ensure that the organization achieves its mission in the most efficient and effective way.

Introduction to International Tax

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Overview of U.S. Income Taxation

- U.S. persons—e.g., citizens, residents, and domestic corporations—are generally subject to U.S. income taxation on their worldwide income regardless of the source.
- Foreign persons—e.g., a nonresident alien or foreign corporation—are generally subject to U.S. taxation on:
  - U.S.-source "FDAP"
  - Income that is effectively connected with the conduct of a U.S. trade or business
  - FIRPTA

Question 1

Billy, are you here?

Income Tax Residents

- Objective Test
  - U.S. Citizens
  - Legal Permanent Resident (a.k.a. the “Green Card” Test)
  - Substantial Presence Test
  - First-year election
- Exceptions to the Substantial Presence Test
  - Certain exempt individuals, including students, teachers, athletes, & government employees
  - Individuals with medical conditions
  - Demonstrate a “Closer Connection “ to another country (Form 8840)
  - Treaty-based exception (Form 8833)

Substantial Presence Test

	Days Present in the United States	Fraction Counted	Days Counted
Non-Resident for 2015			
2013	120	1/6	20
2014	120	1/3	40
2015	120	1	120
		Total	180
Resident for 2015			
2013	120	1/6	20
2014	150	1/3	50
2015	120	1	120
		Total	190

Substantial Presence Test

	Days Present in the United States	Fraction Counted	Days Counted
Medical Exception—Non-Resident for 2015			
2013	120	1/6	20
2014	150, but 30 for medical reasons	1/3	40
2015	120	1	120
		Total	180
All on student visa—Non-Resident for 2015			
2013	180	1/6	0
2014	180	1/3	0
2015	180	1	0
		Total	0

Income Taxation of Nonresident Aliens

- Dual-Status Year Returns
  - No standard deduction, but may claim exemptions for spouse and dependents while a resident.
  - May not file a joint return or file as Head of Household.
  - If you end the year as a resident alien, file Form 1040 with a statement showing income from nonresident portion of the year.
  - If you end the year as nonresident alien, file Form 1040NR with a statement showing income from resident portion of the year.

Question 2

Billy is here as a resident alien under the Substantial Presence Test, but his wife isn't.

If she's not here, what does that mean?

Income Taxation of Nonresident Aliens

- Effectively Connected Income ("ECI")
  - Net-basis taxation for business income
- Gains from the Sale of Real Property—FIRPTA
  - Subject to mandatory 15% withholding, and taxed as ECI
  - Certain taxpayers are subject to 10% withholding
- Fixed, Determinable, Annual, or Periodical Income ("FDAP")
  - All income other than gains from sale of property or income excluded from gross income
    - Dividends
    - Interest
    - Pensions and annuities
    - Alimony
    - Rent and Royalties
  - Gross-basis taxation subject to mandatory 30% withholding
- Gains from the Sale of Non-Real Property—Not Taxed

Income Taxation of Nonresident Aliens

- Billy is a resident alien, but his wife is a non-resident alien.
  - They may elect to have the spouse treated for U.S. income tax purposes as a resident alien.
  - They must file a joint tax return for the first year of the election, but may file separate returns in later years.
  - If they elect to treat the spouse as a resident alien, neither of them may claim to be treated as a non-resident under any tax treaty.

Question 3

If Billy's here, how can he mitigate his U.S. income tax burden?

Mitigating US Income Tax

- Foreign Tax Credit—Form 1116 and Form 1118
  - A credit or an itemized deduction is allowed for taxes paid to a foreign country or U.S. possession if the same income is also subject to U.S. tax.
- Foreign Earned Income Exclusion
  - Up to $107,600 of foreign earned income in 2020
  - Or foreign earned income less foreign housing exclusion
  - Requirements
    - Qualified Individual—either a citizen or resident alien
    - Have foreign earned income
    - Meet the Bona Fide Residence Test or the Physical Presence Test
    - “Tax Home” in a foreign country
    - Valid Election on Form 2555 or Form 2555-EZ

Foreign Tax Credit

Foreign Income	Foreign Tax Rate	Foreign Tax	US Tax (40% rate)	US Foreign Tax Credit	Total Tax (F + US)
$100	0%	0	$40	0	$40
$100	15%	$15	$25	$15	$40
$100	25%	$25	$15	$25	$40
$100	35%	$35	$5	$35	$40
$100	45%	$45	0	$40	$45

Foreign Earned Income Exclusion

Income Type ($100 of each)	Foreign Tax Rate	Foreign Tax	US Tax Rate	US Tax
Foreign Earned Income	10%	$10	0*	$0 ($0 credit)
US Earned Income	0%	0	40%*	$40*
Dividends (US)	0%	0	20%	$20
Dividends (F)	10%	$10	20%	$10 ($10 credit)
Interest (US)	0%	0	40%	$40
Interest (F)	5%	$5	40%	$35 ($5 credit)

* Wages are subject to U.S. Social Security and Medicare taxes

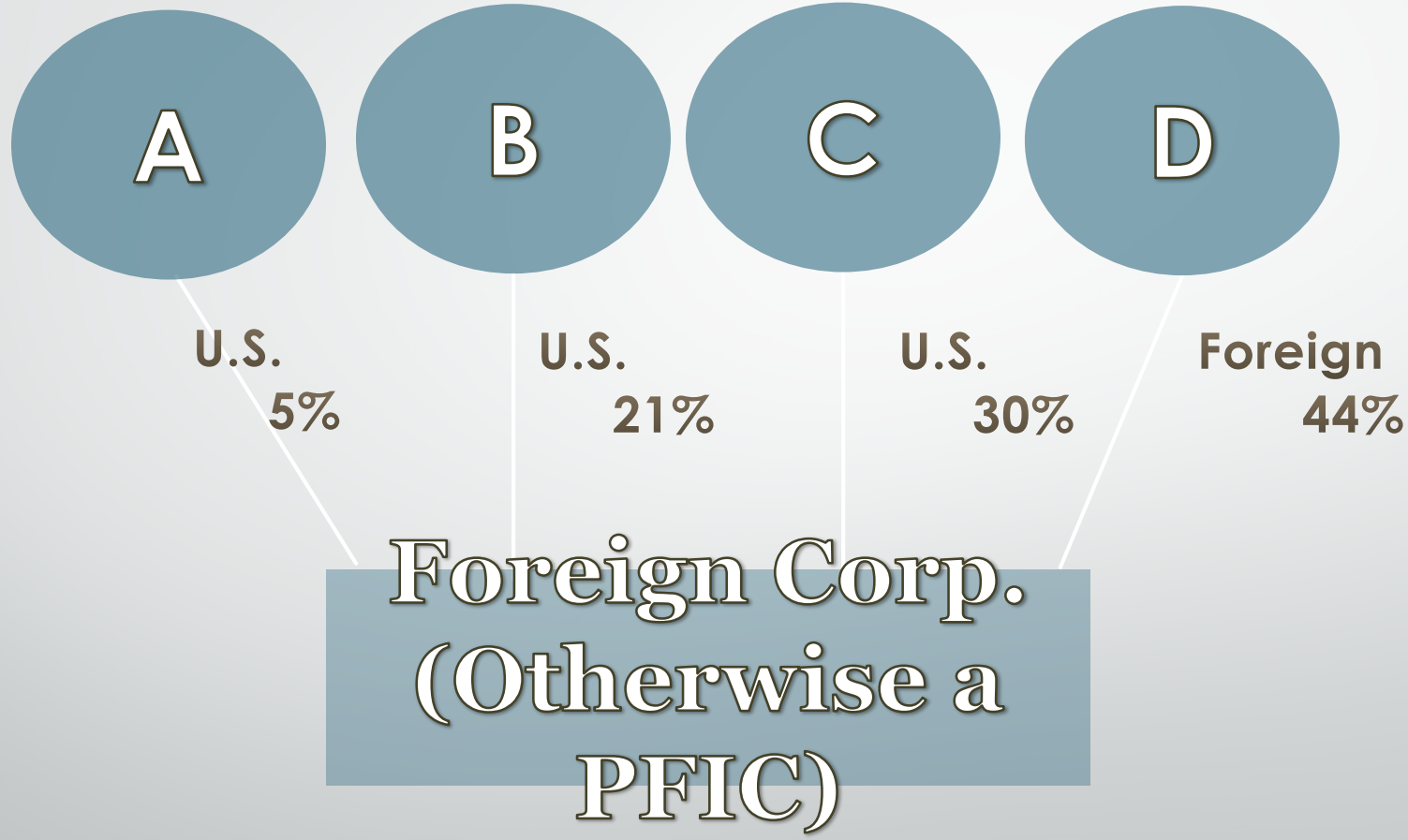
Controlled Foreign Corporation (“CFC”)

- A foreign corporation that has “U.S. shareholders” that own (directly, indirectly, or constructively), more than 50% of:
  - The total combined voting power of all classes of voting stock; or
  - The total value of the stock.

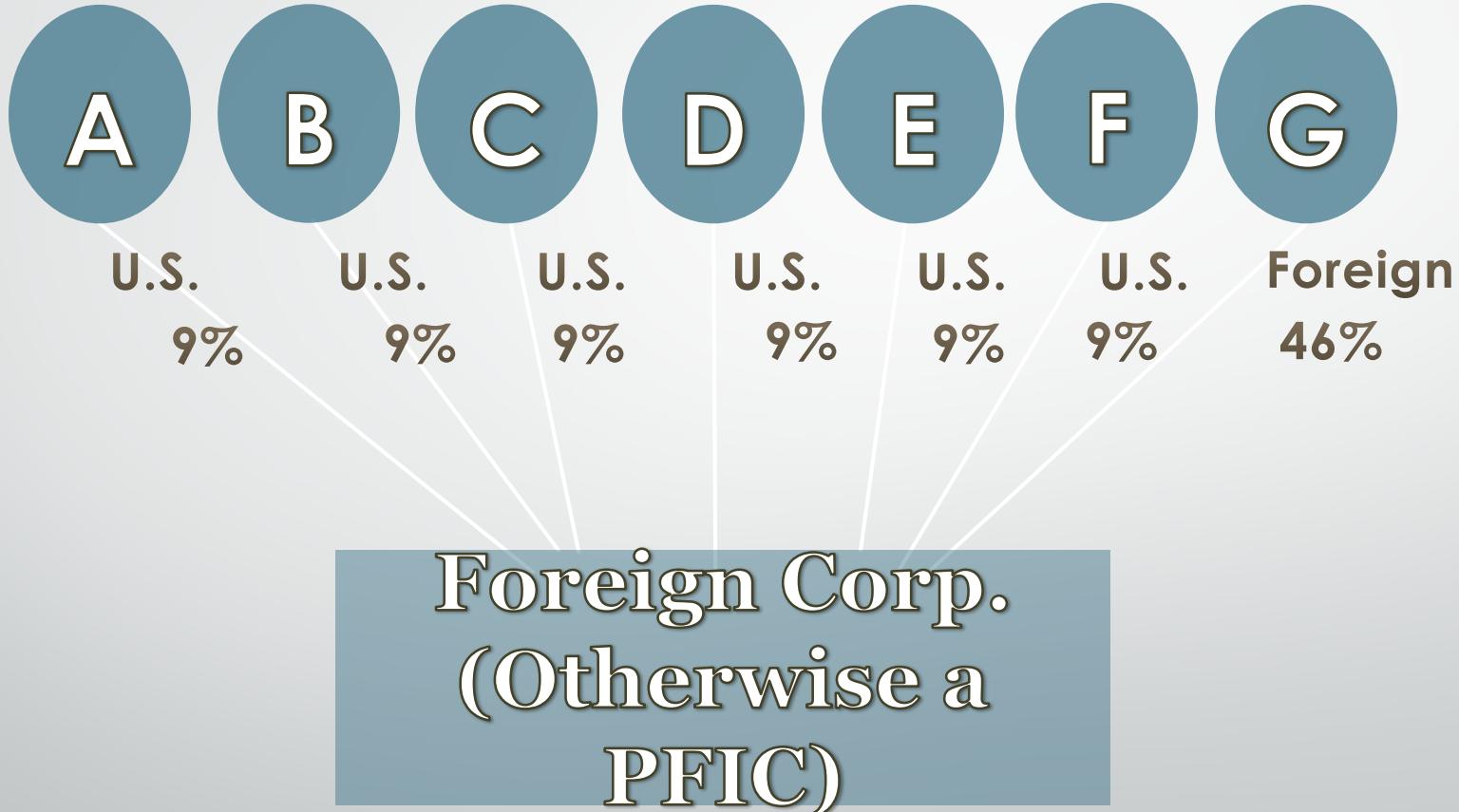
Controlled Foreign Corporation ("CFC")

- A "U.S. shareholder" is, generally, a U.S. person who:
  - Owns (directly, indirectly, or constructively) 10% or more of the total combined voting power or value of all classes of voting stock of a CFC.

Controlled Foreign Corporation (“CFC”)



Controlled Foreign Corporation (“CFC”)



Subpart F Income

- Three key categories of Subpart F income:
  - Foreign Base Company Sales Income
  - Foreign Base Company Services Income
  - Foreign Personal Holding Company Income

PFIC's Defined

- PFIC Tests:
  - Passive Income Test
  - 75% or more of GI is passive income
  - Passive Asset Test
    - 50% or more of assets produce, or are held for production of, passive income

PFIC Tax Regimes

- PFIC Tax Regimes:
  - Excess Distribution (aka “1291 fund”)
  - Qualified Electing Fund (“QEF”)
  - Mark-to-Market

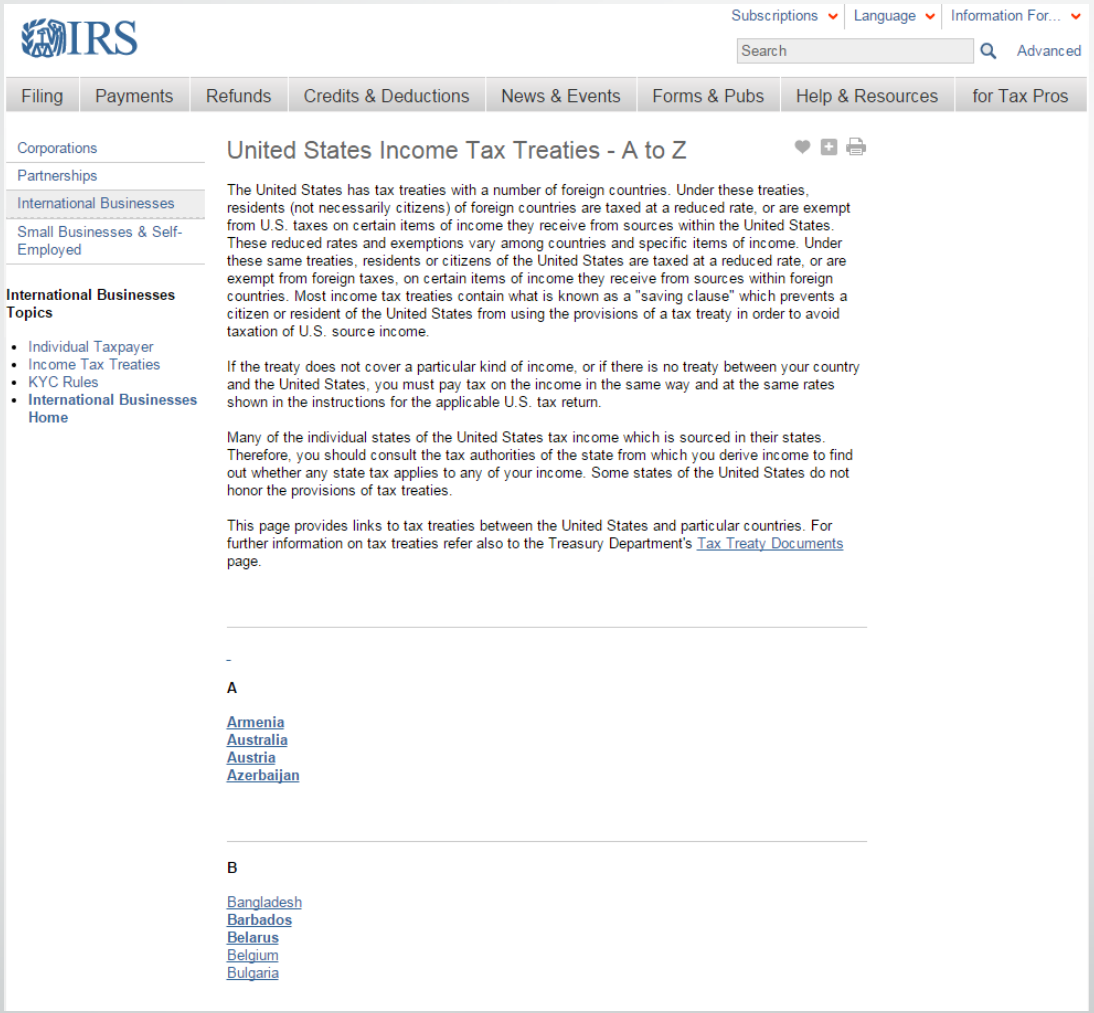
Question 4

Billy, where are you from?

U.S. Income Tax Treaty System

- The U.S.A. is a party to 59 bilateral income tax treaties with 66 countries.
  - The U.S.-U.S.S.R income tax treaty applies to Armenia, Azerbaijan, Belarus, Georgia, Krgyzstan, Tajikistan, Turkmenistan, and Uzbekistan.
  - The U.S.-China income tax treaty does not apply to Hong Kong.
- Four protocols (Japan, Luxembourg, Spain, & Switzerland) were approved by the Senate in 2019.
- Four treaties have been signed but not approved by the Senate.
  - Chile signed in 2010 (first treaty)
  - Hungary signed in 2010 replacing 1979 treaty
  - Poland signed in 2013 replacing the 1974 treaty
  - Vietnam signed in 2015 (first treaty)

U.S. Income Tax Treaties



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- Corporations
- Partnerships
- International Businesses
- Small Businesses & Self-Employed

International Businesses Topics

- Individual Taxpayer
- Income Tax Treaties
- KYC Rules
- **International Businesses Home**

United States Income Tax Treaties - A to Z

The United States has tax treaties with a number of foreign countries. Under these treaties, residents (not necessarily citizens) of foreign countries are taxed at a reduced rate, or are exempt from U.S. taxes on certain items of income they receive from sources within the United States. These reduced rates and exemptions vary among countries and specific items of income. Under these same treaties, residents or citizens of the United States are taxed at a reduced rate, or are exempt from foreign taxes, on certain items of income they receive from sources within foreign countries. Most income tax treaties contain what is known as a "saving clause" which prevents a citizen or resident of the United States from using the provisions of a tax treaty in order to avoid taxation of U.S. source income.

If the treaty does not cover a particular kind of income, or if there is no treaty between your country and the United States, you must pay tax on the income in the same way and at the same rates shown in the instructions for the applicable U.S. tax return.

Many of the individual states of the United States tax income which is sourced in their states. Therefore, you should consult the tax authorities of the state from which you derive income to find out whether any state tax applies to any of your income. Some states of the United States do not honor the provisions of tax treaties.

This page provides links to tax treaties between the United States and particular countries. For further information on tax treaties refer also to the Treasury Department's Tax Treaty Documents page.

A

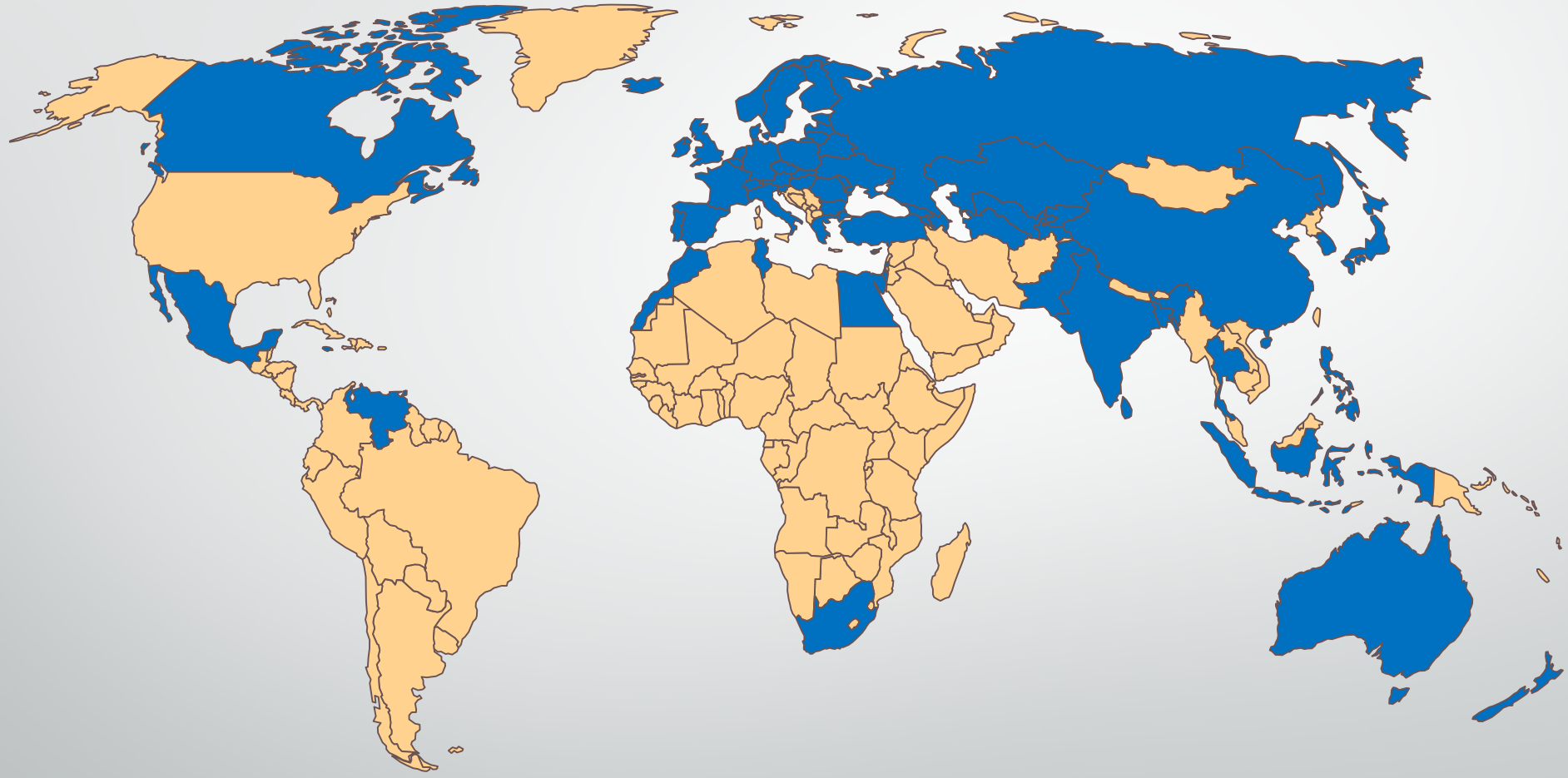
Armenia
Australia
Austria
Azerbaijan

B

Bangladesh
Barbados
Belarus
Belgium
Bulgaria

Available at http://ow.ly/TGSdp

U.S. Income Tax Treaty Partners



Selected Treaty Articles

- Article 2—Taxes Covered
- Article 3—General Definitions
- Article 4—Resident
- Article 5—Permanent Establishment
- Article 6—Income From Real Property
- Article 7—Business Profits
- Article 12—Royalties
- Article 13—Gains
- Article 15—Directors' Fees
- Article 16—Entertainers and Sportsmen
- Article 20—Students and Trainees
- Article 22—Limitation on Benefits
- Article 23—Relief From Double Taxation
- Article 25—Mutual Agreement Procedure

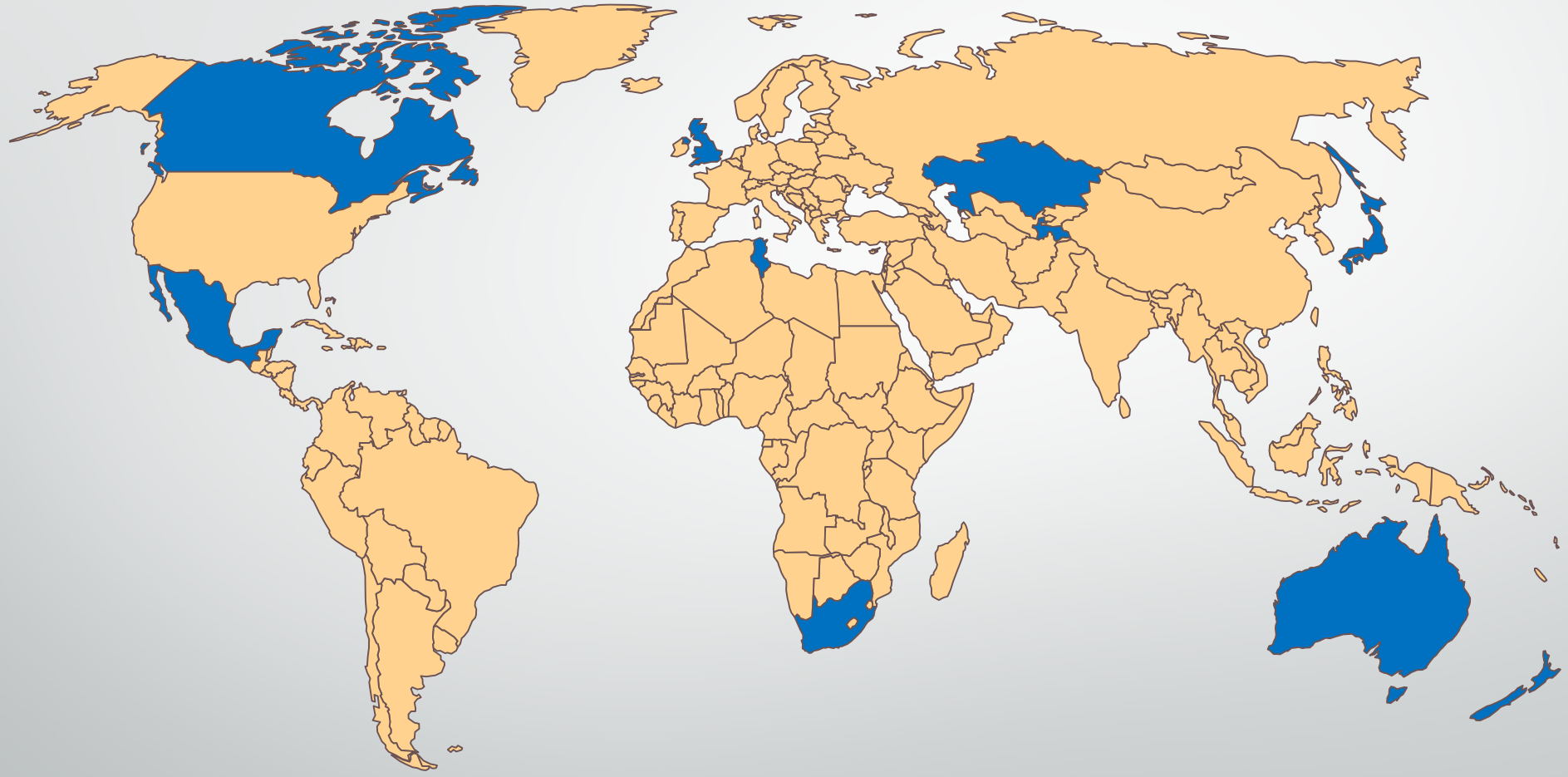
2016 U.S. Model Treaty Updates

- On February 17, 2016, Treasury released a new U.S. Model Income Tax Treaty.
  - New Article 1 Paragraph 7—Exempt Permanent Establishments
  - New Article 3 Paragraph 1(l)—“Special Tax Regime”
  - Changes in Articles 10, 11, & 12—Payments to Expatriated Entities
  - Changes to Article 22—Limitation on Benefits
  - New Article 28—Subsequent Changes in Law

Treaty Comparison

- Australia (effective Dec. 1, 1983, Protocol Jan. 1, 2004)
- Canada (effective Jan. 1, 1985, Protocols Jan. 1, 1996, Dec. 16, 1997, and Jan. 1, 2009)
- Japan (effective Jan. 1, 2005)
- Kazakhstan (effective Jan. 1,1996)
- Mexico (effective Jan. 1, 1994, Protocols Oct. 26, 1995 and Jan. 1, 2004)
- New Zealand (effective Nov. 2, 1983, Protocol Jan. 1, 2011)
- South Africa (effective Jan. 1, 1998)
- Tajikistan (U.S.-U.S.S.R. Income Tax Treaty) (effective Jan. 1, 1976)
- Tunisia (effective Jan. 1, 1990)
- United Kingdom (effective Jan. 1, 2004)

U.S. Income Tax Treaty Comparison



Dividends (Article 10)

- Tax Rate on Dividends Paid by U.S. Corporations
  - No Treaty—30%
  - Model Treaty—5% if owner has 10% ownership, 15% otherwise
  - Australia—15%
  - Canada—15%
  - Japan—10%
  - Kazakhstan—10%
  - Mexico—10%
  - New Zealand—15%
  - South Africa—15%
  - Tajikistan—30%
  - Tunisia—15%
  - United Kingdom—15%

Interest (Article 11)

- Tax Rate on Interest Income Paid by U.S. Obligors
  - No Treaty—30%
  - Model Treaty—15%
  - Australia—10%
  - Canada—0%
  - Japan—10%
  - Kazakhstan—10%
  - Mexico—15%
  - New Zealand—10%
  - South Africa—0%
  - Tajikistan—0%
  - Tunisia—15%
  - United Kingdom—0%

Income From Employment (Article 14)

- No Treaty
  - The recipient is present in the U.S. no more than 90 days during taxable year.
  - The service income does not exceed $3,000.
  - Services are performed as an employee with a nonresident alien, foreign partnership, or corporation not engaged in a U.S. business, or with a U.S. citizen, resident, domestic partnership or corporation for its foreign office.
- $10,000 exempt if present in U.S. for no more than 183 days, not paid by a U.S. resident, and is not borne by a Permanent Establishment
  - Canada
- Exempt if present in the U.S. for no more than 183 days
  - Tajikistan

Income from Employment (Article 14)

- Model Treaty
  - *the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any 12-month period commencing or ending in the taxable year concerned*
  - *the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State*
  - *the remuneration is not borne by a permanent establishment which the employer has in the other State.*
  - Mexico
  - Japan
  - Kazakhstan
  - Australia
  - New Zealand
  - South Africa
  - Tunisia
  - United Kingdom

Pensions & Annuities (Article 17)

- Tax rate on non-governmental pensions & annuities
  - No Treaty—30%
  - Model Treaty—15%
  - Australia—0%
  - Canada—15%
  - Japan—0%
  - Kazakhstan—0%
  - Mexico—0%
  - New Zealand—0%
  - South Africa—15%
  - Tajikistan—30%
  - Tunisia—0%
  - United Kingdom—0%

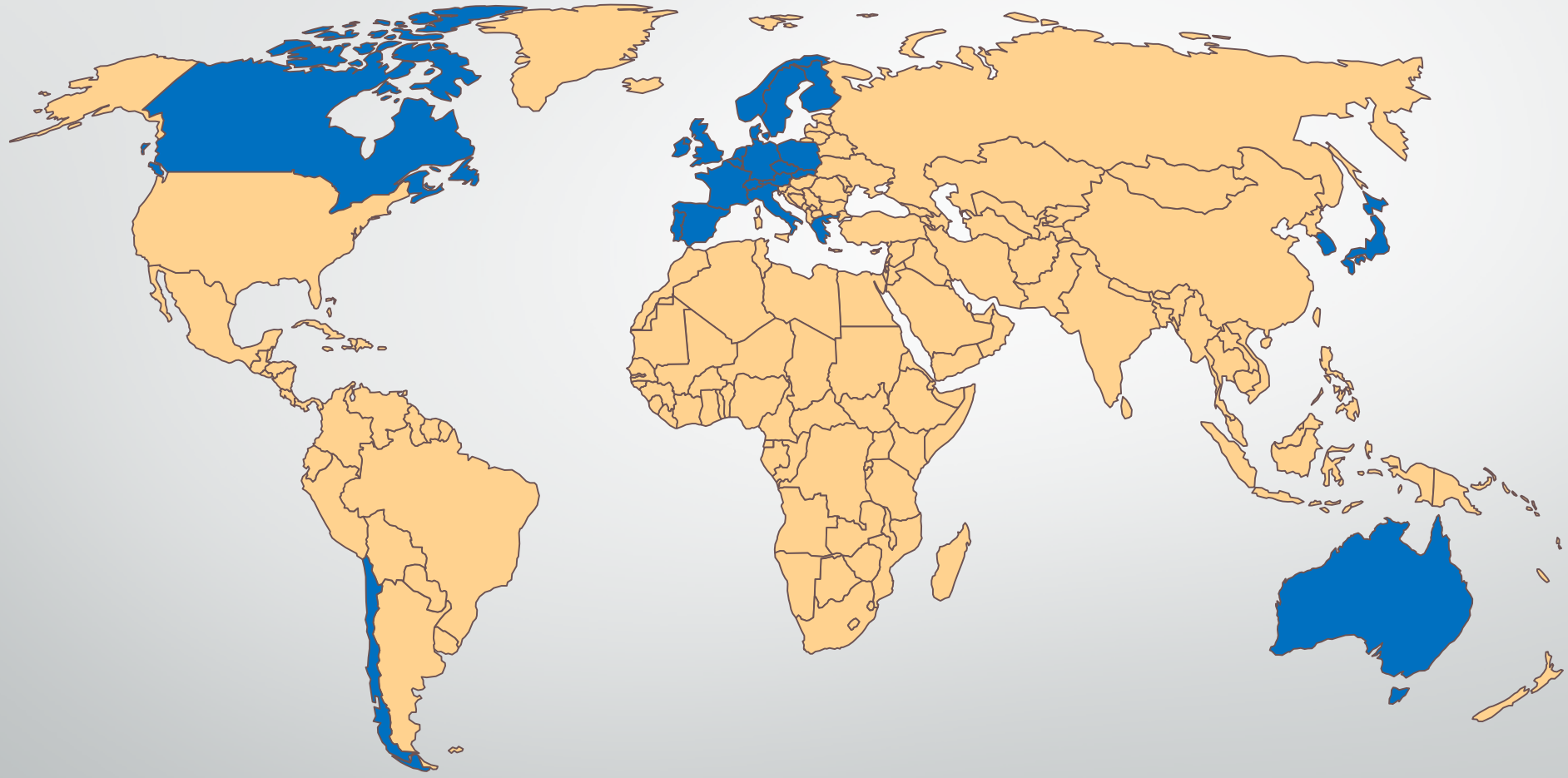
Pensions & Annuities (Article 17)

- Tax rate on U.S. Social Security Payments
  - No Treaty—30%
  - Australia*—30%
  - Canada*—0%
  - Japan*—0%
  - Kazakhstan—30%
  - Mexico—30%
  - New Zealand—30%
  - South Africa—30%
  - Tajikistan—30%
  - Tunisia—30%
  - United Kingdom*—0%
- * Has a Totalization Agreement with the U.S.A.

Totalization Agreements

- The U.S.A. is a party to 25 Social Security Totalization Agreements.
- These agreement ensure coordination between the social security programs of two countries when a taxpayer in one nation works in the other country.
- If a taxpayer is unable to qualify for social security/pension benefits in one country, Totalization Agreements allow credits earned in the other country to be used for qualification in the other country.

Totalization Agreements



Question 8

Billy, have you told the IRS about your assets?

Reporting Obligations

No additional tax is imposed, but penalties are imposed for non-filing

- FinCEN 114—Foreign Bank Account Report ("FBAR") to report foreign bank accounts with more than $10,000
- IRS Form 926—Return by a U.S. Transferor of Property to a Foreign Corporation
- IRS Form 3520—Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts
- IRS Form 3520-A—Annual Information Return of Foreign Trust With a U.S. Owner
- IRS Form 8621—Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund
- IRS Form 8858—Information Return of U.S. Persons With Respect To Foreign Disregarded Entities
- IRS Form 8865—Return of U.S. Persons With Respect to Certain Foreign Partnerships
- IRS Form 8938—Statement of Foreign Financial Assets

Because of space limitations, this list doesn't attempt to be complete

Question 10

What do you mean that you didn’t tell the IRS about every last thing you own on Earth?

Resolving Unmet Reporting Obligations

- Unofficial Options
  - Head in the sand
  - Quiet Disclosures
  - Noisy Disclosures
- Delinquent FBAR Submission Procedures
- Delinquent International Information Return Submission Procedures
- Streamlined Filing Compliance Procedures
  - Streamlined Foreign Offshore
  - Streamlined Domestic Offshore
- Offshore Voluntary Disclosure Program

Question 5

Billy, what do you own?

Transfer Tax Residents

- Transfer Taxes are imposed on U.S. citizens and residents
- Residents are those who are domiciled and primarily residing in the U.S.A. with no definite present intention of leaving, regardless of the time actually present. Treas. Reg. §§ 20.0-1(b), 25.2501-1(b).
- Not a bright-line rule like the Substantial Presence Test, but a facts-and-circumstances test
- All others are considered a “nonresident not a citizen of the United States”

U.S. Estate Taxation of Nonresidents

- Estate Tax applied to property located in the U.S.A.
  - Stock in U.S. corporations (whether or not publicly traded)
  - Real property in the U.S.A.
  - Tangible property in the U.S.A. (e.g., cash in a safe deposit box)
  - Uncertain treatment of foreign partnership interests
  - Revocable trusts
  - $60,000 estate tax exemption
  - Nonrecourse debt on U.S. property results in only net value included in U.S. estate

U.S. Estate Taxation of Nonresidents

- Unlimited marital deduction is available for assets left to U.S.-citizen spouses.
  - A “QDOT” can be established for non-citizen spouses
- Deductions available for charitable contributions and estate administration expenses
  - The deduction is a based on a ratio of U.S. assets to worldwide assets
- Donees take stepped-up basis in transferred property
- DSUE is not available for nonresident non-citizens.

U.S. Gift Taxation of Nonresidents

- Gift Tax applied to property located in the U.S.A.
  - Real property in the U.S.A.
  - Tangible property in the U.S.A. (e.g., cash in a safe deposit box)

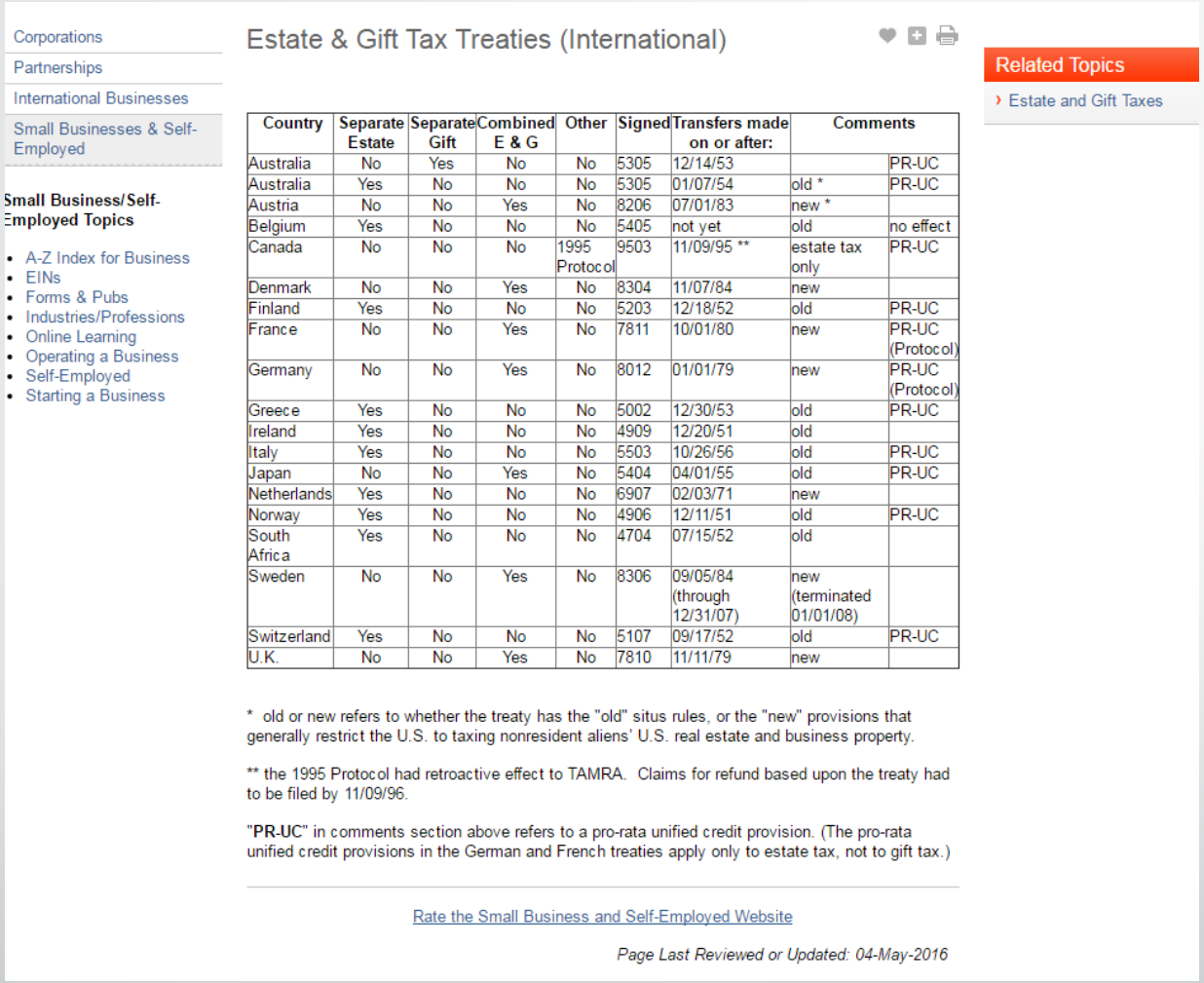
U.S. Gift Taxation of Nonresidents

- No lifetime exemption
- $15,000 Annual Exclusion for gifts to non-spouses in 2020
- $157,000 Annual Exclusion for gifts to non-citizen spouses in 2020
- Unlimited marital deduction for gifts to citizen spouses
- Unlimited exclusions for educational and medical payments
- Donees take a carryover basis in transferred property
- The GST Tax applies if the Estate & Gift Taxes apply
  - $1,000,000 GST exemption(?)

Question 6

Billy, did you tell me where you're from?

U.S. Estate & Gift Tax Treaties



Corporations
Partnerships
International Businesses
Small Businesses & Self-Employed

Small Business/Self-Employed Topics

- A-Z Index for Business
- EINs
- Forms & Pubs
- Industries/Professions
- Online Learning
- Operating a Business
- Self-Employed
- Starting a Business

Estate & Gift Tax Treaties (International)

Country	Separate Estate	Separate Gift	Combined E & G	Other	Signed	Transfers made on or after:	Comments	
Australia	No	Yes	No	No	5305	12/14/53		PR-UC
Australia	Yes	No	No	No	5305	01/07/54	old *	PR-UC
Austria	No	No	Yes	No	8206	07/01/83	new *	
Belgium	Yes	No	No	No	5405	not yet	old	no effect
Canada	No	No	No	1995 Protocol	9503	11/09/95 **	estate tax only	PR-UC
Denmark	No	No	Yes	No	8304	11/07/84	new	
Finland	Yes	No	No	No	5203	12/18/52	old	PR-UC
France	No	No	Yes	No	7811	10/01/80	new	PR-UC (Protocol)
Germany	No	No	Yes	No	8012	01/01/79	new	PR-UC (Protocol)
Greece	Yes	No	No	No	5002	12/30/53	old	PR-UC
Ireland	Yes	No	No	No	4909	12/20/51	old	
Italy	Yes	No	No	No	5503	10/26/56	old	PR-UC
Japan	No	No	Yes	No	5404	04/01/55	old	PR-UC
Netherlands	Yes	No	No	No	6907	02/03/71	new	
Norway	Yes	No	No	No	4906	12/11/51	old	PR-UC
South Africa	Yes	No	No	No	4704	07/15/52	old	
Sweden	No	No	Yes	No	8306	09/05/84 (through 12/31/07)	new (terminated 01/01/08)	
Switzerland	Yes	No	No	No	5107	09/17/52	old	PR-UC
U.K.	No	No	Yes	No	7810	11/11/79	new	

* old or new refers to whether the treaty has the "old" situs rules, or the "new" provisions that generally restrict the U.S. to taxing nonresident aliens' U.S. real estate and business property.

** the 1995 Protocol had retroactive effect to TAMRA. Claims for refund based upon the treaty had to be filed by 11/09/96.

"**PR-UC**" in comments section above refers to a pro-rata unified credit provision. (The pro-rata unified credit provisions in the German and French treaties apply only to estate tax, not to gift tax.)

Rate the Small Business and Self-Employed Website

Page Last Reviewed or Updated: 04-May-2016

Related Topics

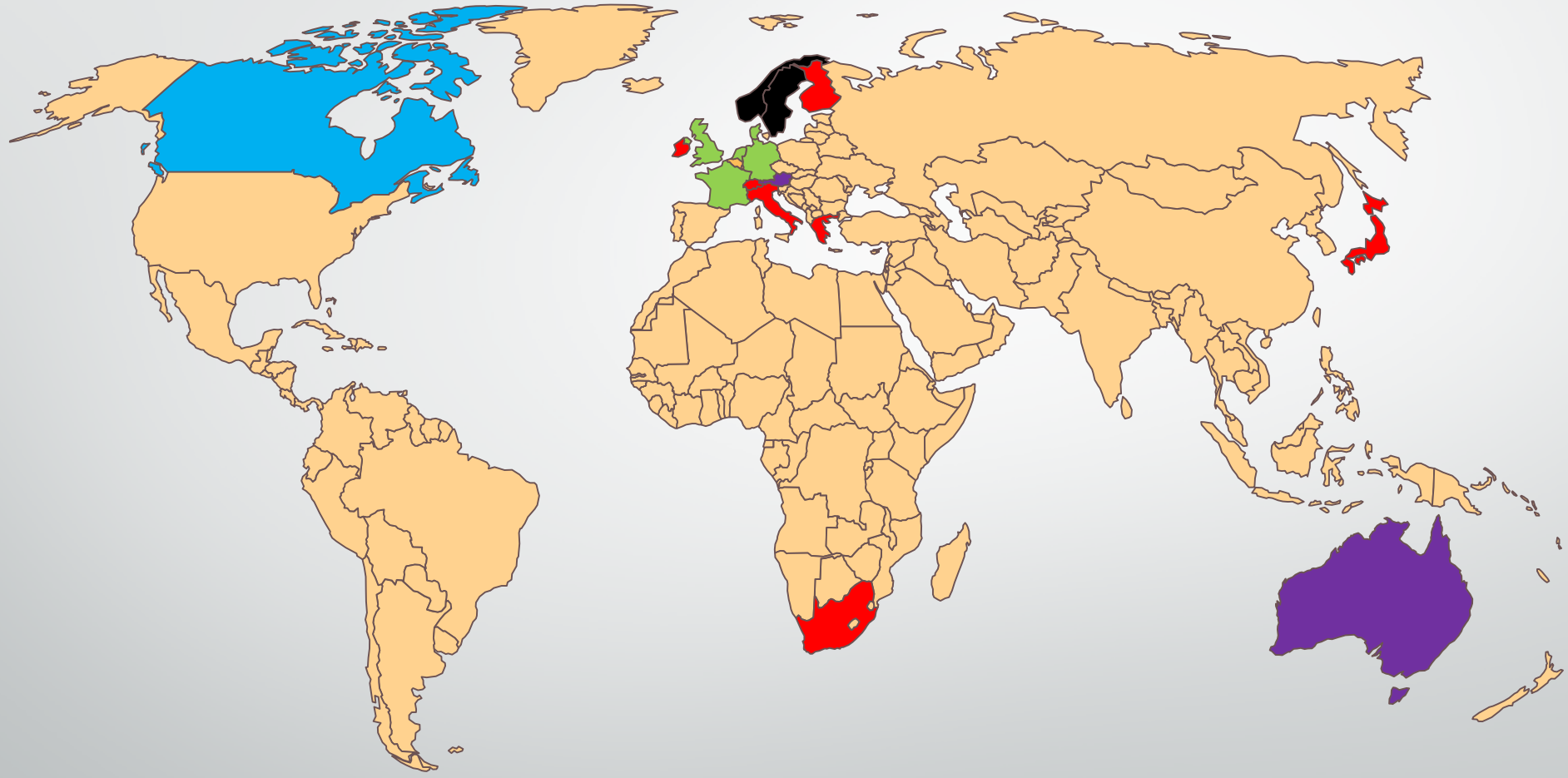
› Estate and Gift Taxes

No longer available. ¯_(ツ)_/¯

Estate & Gift Tax Treaties

- 7 Situs-Type Treaties
  - Allocation taxation of assets to jurisdictions based on the situs of the assets.
  - Treaties with ~~Australia~~, Finland, Greece, Ireland, Italy, Japan, ~~Norway~~, South Africa, & Switzerland.
- 6 Domicile-Type Treaties
  - Allocate taxation of assets to jurisdictions based on the domicile of the taxpayer.
  - Treaties with ~~Austria~~, Denmark, France, Germany, Netherlands, ~~Sweden~~, & the United Kingdom.
  - Protocol Amending United States-Canada Income Tax Treaty.

U.S. Estate & Gift Tax Treaty Partners



Question 7

Billy, do you have any assets located in the European Union?

Brussels IV

- The Succession Regulation, Regulation No 650/2012, became effective on August 17, 2015.
- It attempts to harmonize succession law in the EU by allowing testators to elect in writing to have their national law apply to the disposition of property in EU member states
  - The United Kingdom, Ireland, and Denmark opted out of the application of the Succession Regulation.

Question 8

But what about your foreign corporate entities?

Imputed Income from Foreign Entities

- Controlled Foreign Corporations (CFC)
- PFICs
- GILTI

Question 11

Billy, are you the beneficiary of any trusts?

Throwback Tax

California has its own Throwback Tax, and it is different from the Federal Throwback Tax

Question 12

Billy, are you expecting any gifts from Covered Expatriates?

Our New Inheritance Tax

- Code § 2801 imposes a 40% inheritance-style tax on transfers from Covered Expatriates to Estate & Gift Tax Residents.
- The annual exclusion applies, but the medical and education exemptions don't apply.
- The tax is not imposed if the transferor files Form 706 or 709.
- This will not be imposed until the Treasury Regulations have been finalized.
- Example: $50,000 gift for tuition paid directly to the institution
  - After the $14,000 annual exclusion, $36,000 remains subject to tax.
  - 40% x $36,000 = $14,400 tax that Billy, not the transferor, must pay.

Question 13

Billy, have you had enough?

Expatriation

- "Covered Expatriates" under Code § 877A includes U.S. citizens and long-term U.S. residents who cease to be permanent U.S. residents.
- Three-prong test to not be a Covered Expatriate
  - Average annual net income tax bill for the five prior years ending before expatriation under $171,000 in 2020
  - Net worth under $2,000,000 on date of expatriation
  - Certify on Form 8854 that you've complied with all U.S. federal tax filing obligations
- Tax on mark-to-market valuation of assets on the day before expatriation.

Takeaways

- The rules are usually upside down and backwards when dealing with international transactions.
- Even if your clients aren't dealing with international tax issues, their children almost certainly will.
- Brussels IV makes it easier to coordinate the disposition of property in the EU (except for the UK, Ireland, & Denmark).
- The Foreign Tax Credit is far easier to obtain than the Foreign Earned Income Exclusion.
- If property crosses a border, it probably needs to be reported.

State Bar of Texas Tax Section
Tax Law in a Day
February 7, 2020
Houston, Texas

Cryptocurrency – An Overview of IRS Enforcement Efforts to Ensure Compliance

Presented By:
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Virtual Currency

- ***What is Virtual Currency?*** Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency -- i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance -- but it does not have legal tender status in any jurisdiction. *See* IRS Notice 2014-21.
- ***What is Cryptocurrency?*** Cryptocurrency is a type of virtual currency that uses cryptography to secure transactions that are digitally recorded on a distributed ledger, such as blockchain. A crypto transaction recorded on the distributed ledger is an "on-chain" transaction; a transaction not recorded on the distributed ledger is an "off-chain" transaction. *See* Rev. Rul. 2019-24.

Notice 2014-21, March 25, 2014

- ***Tax Consequences***. In general, the sale or exchange of convertible virtual currency, or the use of convertible virtual currency to pay for goods or services in a real-world economy transaction, has tax consequences that may result in a tax liability.
- ***"Property" for Tax Purposes***. Virtual currency is treated as property for U.S. tax purposes. General tax principles applicable to property transactions apply to transactions using virtual currency.
- ***Gain/Loss***. The character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. A taxpayer generally realizes capital gain or loss on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer. For example, stocks, bonds, and other investment property are generally capital assets. A taxpayer generally realizes ordinary gain or loss on the sale or exchange of virtual currency that is not a capital asset in the hands of the taxpayer.
- ***Information Reporting***. Payments made using virtual currency must be reported on Form 1099-MISC, using FMV of the virtual currency on date of payment.

IR-2018-71, March 23, 2018

- IRS reminds taxpayers to report virtual currency transactions
- Taxpayers who do not properly report the income tax consequences of virtual currency transactions can be audited for those transactions and can be liable for penalties and interest.
- In more extreme situations, taxpayers could be subject to criminal prosecution for failing to properly report the income tax consequences of virtual currency transactions.

FAQ on Virtual Currency Transactions, October 9, 2019

- IRS recently published a 43 question-and-answer FAQ on how taxpayers should report virtual currency transactions.
- ***Holding Period*** - Begins on day after taxpayer acquired virtual currency and ends on day of sale.
- ***Cost Basis*** - Basis in virtual currency is the amount spent (in U.S. dollars) to acquire the virtual currency, including fees, commissions, and other acquisition costs.
- **Calculating basis** in cryptocurrency received via (i) Peer-to-peer transaction, (ii) Exchange Platform (e.g., Coinbase), (iii) Hard fork, and/or (iv) Hard fork + airdrop.
- ***Specific Identification vs. FIFO*** - Taxpayers may specifically identify the unit(s) of virtual currency they sale or exchange for purpose of calculating gain/loss. If taxpayer does not specifically identify the specific units sold, should use first in, first out (FIFO) basis for determining gain/loss.
- ***Gift Transfers*** – If taxpayer receives virtual currency as bona fide gift, no recognition of income until taxpayer sells, exchanges, or disposes of virtual currency. Basis in gift depends on whether there is gain/loss upon disposition (if no documentation to substantiate donor's basis in virtual currency, taxpayer/recipient's basis is ZERO).

Revenue Ruling 2019-24, October 9, 2019

- Guidance on how to report "hard fork" and "airdrop" cryptocurrency transactions.
- ***"Hard Fork"*** – when a cryptocurrency undergoes a protocol change or "split" resulting in a permanent diversion from the legacy distributed ledger. A hard fork may result in the creation of a new cryptocurrency on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger.
- ***"Airdrop"*** – an airdrop is a mean of distributing units of cryptocurrency to the distributed ledger addresses of multiple taxpayers.
- ***Hard Fork + Airdrop*** – a hard fork followed by an airdrop results in the distribution of units of the new cryptocurrency to addresses containing the legacy cryptocurrency.
- ***Tax Consequences.*** A hard fork is not always followed by an airdrop. If a hard fork occurs, but the taxpayer does not receive units of a new cryptocurrency, then no gross income under IRC § 61. If hard fork occurs and taxpayer receives units of new cryptocurrency via airdrop, taxpayer has gross income under IRC § 61.

Application of FinCEN Regulations to Virtual Currency

- A user of virtual currency is ***not*** an MSB under FinCEN's regulations and therefore is not subject to MSB registration, reporting, and recordkeeping regulations.
- However, an administrator or exchanger is an MSB under FinCEN's regulations, specifically, a money transmitter, unless a limitation to or exemption from the definition applies to the person.
  - FIN-2-13-G001

Title 31 Regulation

18 U.S.C. § 1960 – Operation of an Unlicensed Money Service Business

Businesses must be registered as a money transmitting business with the Secretary of the Treasury Department's Financial Crimes Enforcement Unit (FinCEN) as required by Title 31 U.S.C. Section 5330.

This applies to domestic and foreign based MSBs conducting substantial business in the United States.

Failure of administrators/exchangers to register as an MSB is usually a good indicator that the entity lacks knowledge of anti-money laundering requirements including the Funds Transfer and Funds Travel Rules.

Virtual Currency Enforcement Specialist

- What is a FinCEN Virtual Currency Enforcement Specialist?
  - Analyze, research, describe, and assess financial institutions, or their partners, directors, officer, or employees, operating in convertible virtual currency for their compliance with the U.S. anti-money laundering/combating the financing of terrorism (AML/CFT) regulatory framework;
  - Conduct research and build compliance and enforcement cases and organize their supporting evidence, as well as analyze and prioritize targets based on FinCEN priorities;

Virtual Currency Enforcement Specialist (2)

- Participate in the formulation, planning, development, and implementation of compliance and enforcement strategies related to virtual currency businesses that have industry-wide, national, or international impact, including those related to national security.
- Serve as a technical expert regarding cryptocurrency, blockchain analytics, and cyber intelligence gathering tools in order to produce sophisticated analyses, assess the darknet, and conduct blockchain analytics.

IRS-CI Evolution on Virtual Currency

- IRS-CI formed a team in 2013 to study the use of virtual currencies to avoid taxes by moving money in and out of offshore accounts.
- IRS-CI is forming specialized teams with expertise to develop high-impact cases.

Evolution of Virtual Currency (1)

- IRS-CI began looking into Virtual Currency in 2013
- At the time IRS-CI involved with a lot of Identity Theft Crimes (IDT) involving tax returns
- Those crimes evolved to Cyber IDT often times involving the dark web and virtual currency

Evolution of Virtual Currency (2)

- **Cyber Crimes HQ Office**: Oversees the nationwide implementation of IRS-CI cybercrime programs. Develop policy, strategy and investigative support issues.
- **Cyber Crimes Units**: IRS-CI has two fully operational CCUs (Washington DC and Los Angeles) staffed with technology savvy special agents, investigative analysts, data/software engineers, computer investigative specialist, and other support personnel.
- **Field Office Cyber Coordinators**: CI has 21 Lead Cyber Coordinators in each of our 21 field offices.
- **Cyber Support Unit**: CI recently stood up a Cyber Support Unit with eight investigative analyst and one supervisory investigative analyst solely focused on supporting cyber investigations
- **National Cyber Forensic and Training Alliance**: IRS-CI assigned a CCU SA to act as a liaison officer at NCFTA Headquarters. This is a partnership between private industry, government, and academia for the sole purpose of identifying, mitigating, and disrupting cyber crime.

Evolution of Virtual Currency (3)

- **European Cybercrime Centre**: A CCU special agent is assigned to the EC3 as a liaison officer in Netherlands.
- **Nationally Coordinated Investigations Unit**: An embedded unit within CI that is using Data Analytics to build typologies in various financial driven crimes to include cybercrime
- **Cyber Undercover Program**: IRS-CI launched a cyber undercover program to train cyber agents to conduct undercover operations online.
- **Cyber Fusion Team**: CI led coordination within IRS to share real-time intelligence from the Dark Web and other online sources.
- **Joint Chiefs of Global Tax Enforcement (J5)**: In 2018, IRS-CI teamed up with tax authorities from the United Kingdom, Canada, Australia, and the Netherlands. The J5 are committed to combatting transnational tax crime through increased enforcement collaboration. The J5 will work together to gather information, share intelligence, conduct operations and build the capacity of tax crimes, money laundering and cyber crime enforcement.

IRS-CI Priorities (Virtual Currency)

- Intersection of Cyber and Financial Crimes = Virtual Currency
- IRS-CI follows the digital money
- Pursuing tax (Title 26) and money laundering (Title 18) violations
- Crypto Kiosks
- Dark web marketplaces

IRS Tracing Virtual Currency Transactions

- ***IRS Tracing "Anonymous" Bitcoin Transactions*** - IRC-CI is contracting with blockchain analysis services to create a path of transactions that may be followed through the Bitcoin blockchain to connect off-chain identities with Bitcoin addresses. *See e.g.,* IRS Contract with Chainalysis
- In October 2019, the U.S. Attorney's Office for the District of Columbia announced that IRC-CI had traced Bitcoin transactions to identify and takedown the largest child exploitation website on the darkweb. By analyzing the blockchain and de-anonymizing bitcoin transactions, the IRS was able to identify hundreds of predators around the world – despite the users' likely assumption the Bitcoin transactions were anonymous. (Link)

Notable Investigative Highlights

- Liberty Reserve
- BTCe
- Silk Road I and II
- Alphabay
- In all investigations, CI was the lead agency in the cryptocurrency tracing and ultimately the attribution of main targets or the associated network servers.

IRS Areas of Focus

Virtual currency tax compliance is an IRS priority.

- The IRS is focused on enforcing tax compliance for holders of virtual currency.
- Virtual currency is ongoing focus area for the IRS and IRS Criminal Investigation using all available compliance avenues:
  - examination
  - criminal prosecution
  - data analytics
- Compliance efforts are focused on enforcing the law and helping taxpayers fully understand and meet their obligations.
- Virtual currency is an asset and is treated as such in IRS examination and collection activities.
- Interviews with taxpayers now routinely include questions about virtual currency assets and transactions.

Reporting Virtual Currency Transactions

- IRS Notice 2014-21 & Revenue Ruling 2019-24
  - states that virtual currency is property for federal tax purposes
  - provides guidance on how general federal tax principles apply to virtual currency transactions.
- Transactions in virtual currency should follow analogous property taxation rules.
- When applying these rules taxpayers should take positions that are reasonable and consistent.
- The IRS anticipates issuing additional legal guidance in this area.

IRS Compliance Activities

- Current activities include
  - Guidance
  - Training
  - Communications and education
  - Coordination efforts

Guidance

- Guidance for employees working cases involving virtual currency
  - Sept 2018 – Formed Collection Virtual Currency Team, tasked with developing policy and guidance on collection strategies
  - Ongoing – Guidance to Field Collection, summons guidance, IRM guidance
  - Communication efforts include a new section on internal website and articles in newsletters reaching CEASO, ATAT and International employees.
  - Coming soon: Additional guidance pending on levy, seizure and sale procedures, and glossary of terms.

Training

- Training for employees working cases that involve virtual currency
  - New and revised training materials
  - CPEs
  - Each Field Collection Area selected a subject matter expert who received face-to-face training to be shared with ROs, advisers, PALS
  - Virtual Currency Toolkit

IRS Educational Letters

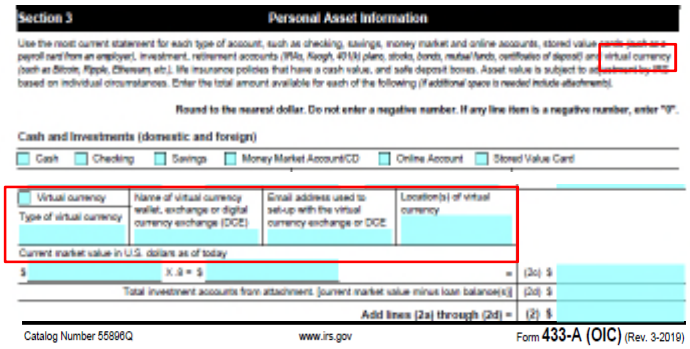
- July 26, 2019 – IRS announced it began sending educational letters to taxpayers with virtual currency transactions (IR-2019-132)
- More than 10,000 taxpayers received letters.
- Three variations of the educational letter: Letter 6173, 6174 and 6174-A.
- All versions strive to help taxpayers understand their tax and filing obligations and how to correct past errors.

IRS Educational Letters

- Letters advised taxpayers to review tax filings and when appropriate, amend past returns and pay back taxes, interest and penalties.
- Names of taxpayers were obtained through various ongoing IRS compliance efforts.
- Taxpayers are pointed to information on IRS.gov, including which forms and schedules to use and where to send them.

Updated Forms and Publications

- Collection Information Statement (Form 433-A) updated to request information on virtual currency
- Instructions (Pub. 1854 and 5059) also updated



Section 3 **Personal Asset Information**

Use the most current statement for each type of account, such as checking, savings, money market and online accounts, stored value cards (such as a payroll card from an employer), investment, retirement accounts (IRAs, Keogh, 401(k) plans, stocks, bonds, mutual funds, certificates of deposit) and virtual currency (such as Bitcoin, Ripple, Ethereum, etc.), life insurance policies that have a cash value, and safe deposit boxes. Asset value is subject to adjustment by IRS based on individual circumstances. Enter the total amount available for each of the following (If additional space is needed include attachments).

Round to the nearest dollar. Do not enter a negative number. If any line item is a negative number, enter "0".

Cash and Investments (domestic and foreign)

☐ Cash ☐ Checking ☐ Savings ☐ Money Market Account/CD ☐ Online Account ☐ Stored Value Card

☐ Virtual currency Type of virtual currency	Name of virtual currency wallet, exchange or digital currency exchange (DCE)	Email address used to set-up with the virtual currency exchange or DCE	Location(s) of virtual currency

Current market value in U.S. dollars as of today

$ _____ X .8 = $ _____ = (2c) $

Total investment accounts from attachment [current market value minus loan balance(s)] (2d) $

Add lines (2a) through (2d) = (2) $

Catalog Number 55896Q www.irs.gov Form **433-A (OIC)** (Rev. 3-2019)

Coordination Efforts

- Within IRS
  - National Cryptocurrency Issue Team – works on virtual currency issues with cross-functional impact; coordinate strategies and share initiatives
  - Collection Virtual Currency (CVC) team working with IRS-CI, Collection, Counsel
- Other federal law enforcement

Key Points

- Compliance efforts are focused on enforcing the law, educating taxpayers so they can meet their obligations.
- Taxpayers who do not properly report the income tax consequences of virtual currency transactions:
  - are, when appropriate, liable for tax, penalties and interest.
  - In some cases, could be subject to criminal prosecution.
- IRS anticipates issuing more legal guidance in this area in the near future.
- More information: IRS.gov, search "virtual currencies"

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Mr. Villa's practice concentrates on resolving federal tax controversies and white collar crime such as securities, tax and bank fraud. He represents individuals, closely-held businesses, and large corporations in IRS audits, appeals, and litigation. Mr. Villa represents individuals and entities in business disputes and lawsuits involving fraud, breach of contract, breach of fiduciary duty, deceptive trade practices act violations, non-compete violations, business torts, and other commercial disputes.

In 2010-2013, Mr. Villa was named a Texas Rising Star, and in 2013-2014 he was named a Texas Super Lawyer as listed in *Texas Monthly* and *Texas Super Lawyer Magazine*, and on the web at superlawyers.com.

Prior to joining the firm in 2007, he worked in Washington, D.C. as a Congressional intern to U.S. Senator John Breaux (Retired) and worked as an Associate with a regional law firm in New Orleans, Louisiana. In 2004-2005, he served as a Judicial Clerk to the Honorable James J. Brady, U.S. District Court, Middle District of Louisiana.

Mr. Villa was admitted to practice in Louisiana in 2004 and in Texas in 2005.

DISCLAIMER

The information included in these slides is for discussion purposes only and should not be relied on without seeking individual legal advice.

Common Tax Issues in Partnership and Real Estate Transactions

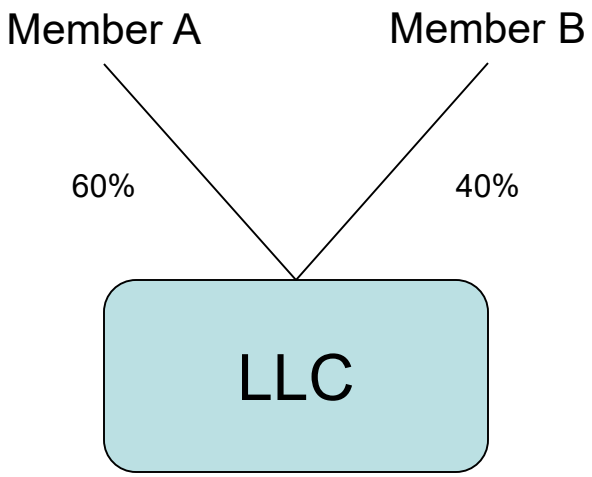
Trip Dyer

Tax Law in a Day

February 7, 2020

WINSTEAD

Partnership Taxation



- Partnerships are flow-through entities
  - Income, gain and loss are recognized at the entity level, but partnership does not pay tax itself
  - Income, gain and loss flow through to the partners, who take the items into account on their own tax returns
  - Generally, contributions of cash or property to a partnership do not result in tax
  - Generally, distributions of cash or property to a partner do not result in tax

Issue: Choice of Entity

"I'm putting together a new real estate venture. I want to form a corporation to take advantage of the new 21% rate."

Choice of Entity: Effective Tax Rate

C Corporation		Partnership	
Taxable Income	$ 100.00	Taxable Income	$ 100.00
Corporate Rate	21%	Partnership Rate	0%
Corporate Tax Liability	$ 21.00	Partnership Tax Liability	$ -
Net Cash to Distribute	$ 79.00	Net Cash to Distribute	$ 100.00
Individual Rate	20%	Individual Rate	37%
NII Rate	3.80%	NII Rate (if applicable)	3.80%
Individual Tax Liability	$ 18.80	Individual Tax Liability	$ 40.80
Total Tax Liability	$ 39.80	Total Tax Liability	$ 40.80

- Currently, small rate difference in favor of corporations
  - Assuming taxpayer is in highest bracket, NII tax is applicable and no partnership income deduction
- Generally, still prefer partnerships to corporations
  - Greater flexibility (e.g., issuance of profits interests, TIC like-kind exchanges)
  - Individual and corporate rates may change in the future
  - Changing from corporate form to partnership can result in a large tax bill
  - Losses flow through to partners

Deduction for Partnership Income

- 2017 Tax Act provides non-corporate partners with a deduction of up to 20% of their "qualified business income"
- Qualified business income: generally, income from a trade or business that is not a "specified service trade or business"
  - Rental real estate (other than triple net leases) may be treated as a trade or business for these purposes
  - Excludes investment items (capital gain or loss, dividends, interest), compensation, partnership guaranteed payments
  - Specified service: law, accounting, businesses where the principal asset is the reputation or skill of employees (excludes architecture and engineering)
- For taxpayers with income over certain thresholds ($415,000 married filing jointly), limited to the greater of:
  - 50% of W-2 wages paid by a trade or business, or
  - 25% of W-2 wages + 2.5% of unadjusted basis of tangible depreciable property
  - Entities may be aggregated for purposes of determining W-2 wages and basis

Choice of Entity: Considerations

- For federal income tax purposes, an LLC with multiple members is taxed as a partnership by default
- Typically, LLCs are recommended
  - Greater management flexibility than limited partnerships, which must have a general partner
  - Certain business (investment funds, oil and gas, real estate) based in Texas may benefit from being formed as a limited partnership, however
- Texas Franchise Tax
  - Generally, a .75% tax on revenues exceeding $1,180,000
  - Franchise tax does not apply to “passive entities”
    - At least 90% of gross income from passive sources
  - Limited partnerships can be passive entities
  - LLCs ***cannot*** be passive entities

Issue: Employees as Partners

"I'm bringing in a new employee as a 'partner' in my LLC."

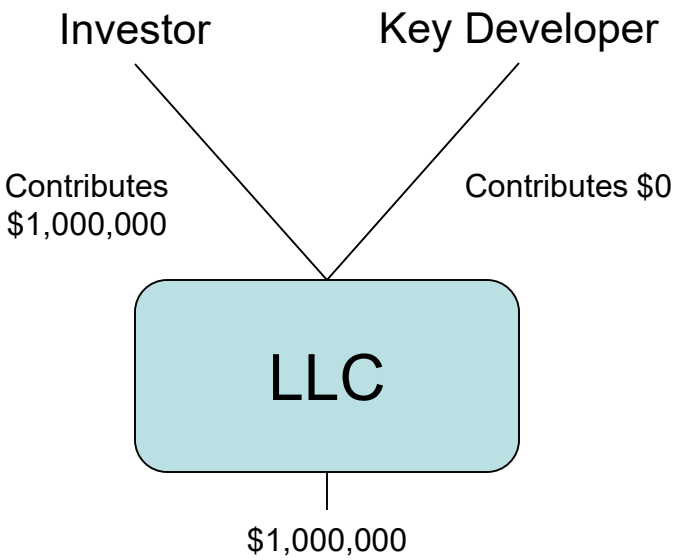
Employees as Partners

- An individual who is a partner of a partnership cannot be an employee of the partnership, for federal income tax purposes
- Generally, an employee would not want to be taxed as a partner
  - Receive Schedule K-1 (allocated income) instead of Form W-2 (wages); potential phantom income
  - Pay estimated taxes quarterly
  - May be subject to taxes in other states where partnership does business
  - Limitations on benefits (e.g., payment of group health benefits)
  - Subject to self-employment taxes (pay 100%) rather than employment taxes (pay 50%)
- It is possible to structure around this issue by having the employee own a partnership interest in or be employed by a different entity

Issue: Capital Shift

"I have a new real estate business or development that I'm creating. I'm putting in $1 million, I have a key developer that I need to hire or engage, and I'm going to give him a 10% interest in the new deal, so we're going to form an LLC. I'll put in $1 million and we'll allocate income, losses and distributions 90/10."

Capital Shift



- This results in a taxable transaction
  - Key Developer was granted property (the LLC interest) that was worth $100,000
- If the LLC liquidated on the date of formation, Key Developer would receive $100,000 and Investor would receive $900,000
- Results in $100,000 of taxable income for Key Developer as of the date of issuance of the LLC interest

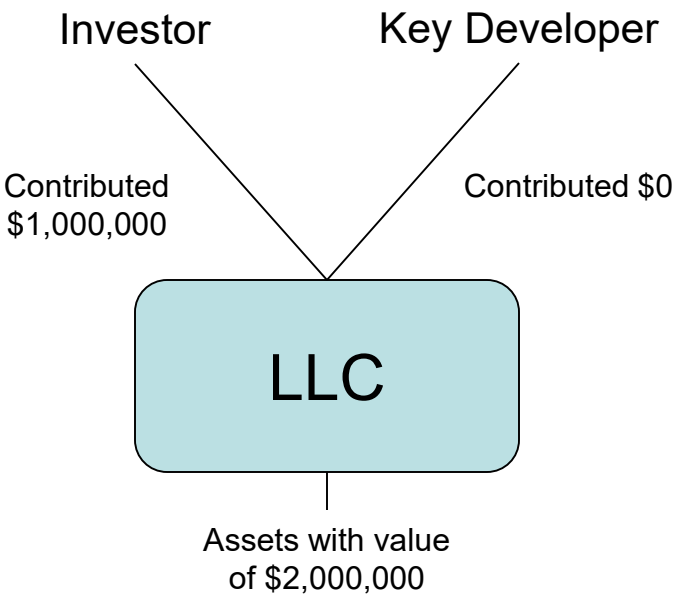
Solution: Profits Interest

- Key Developer could be granted a “profits interest”
  - Also referred to as a promote interest or carried interest
  - Profits interest, by definition, would not receive a distribution if the LLC liquidated immediately after formation
- Capital event waterfall should be drafted to ensure Key Developer is granted a profits interest
  - Example (grant of profits interest on initial formation):
    - First, to the Members pro rata in accordance with their Unreturned Capital Contributions until the Unreturned Capital Contribution of each Member has been reduced to zero, and
    - Thereafter, 90% to Investor and 10% to Key Developer
  - Because Investor would receive all of its capital contributions before the 90/10 split, key manager/developer would not receive a distribution if the LLC liquidated on the date of formation. Thus, the profits interest has a value of $0 on date of grant
- If a profits interest is granted after the initial formation, the entire value of the LLC, as of the date of grant, must be distributed upon a capital event before the profits interest receives distributions

Issue: Catch-Ups

“So, how can I get the key developer to the same place where he gets 10% of the economics of the deal without immediate taxation?”

Example: **No** Catch-Up Distribution

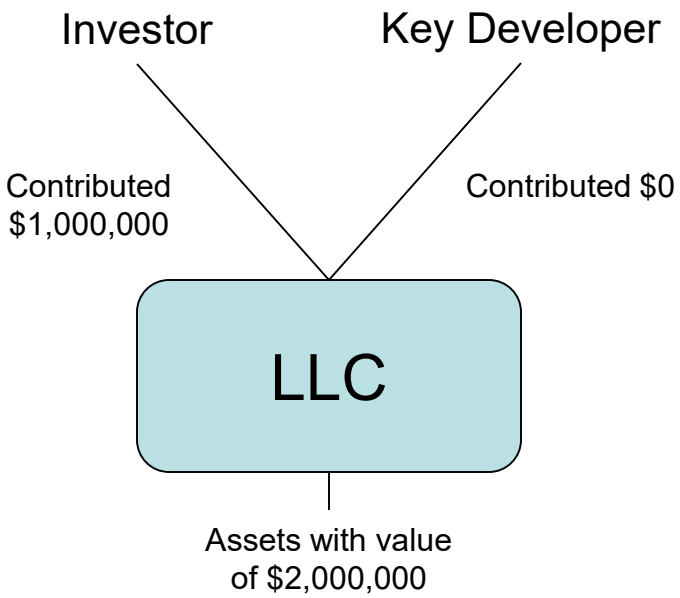


- Example: LLC sells assets and has $2,000,000 to distribute
  - First, Investor receives $1,000,000 as a return of its capital contribution
  - Next, Investor receives $900,000 (90%) and Key Developer receives $100,000 (10%)
- Investor received $1,900,000 of distributions (95%)
- Key Developer received $100,000 of distributions (5%)

Solution: Catch-Up Distribution

- To ensure that Key Developer receives 10% of all distributions, without causing a capital shift, the waterfall can include a catch-up provision
- Example:
  - (a) First, 100% to the Members pro rata in accordance with their Unreturned Capital Contributions until the Unreturned Capital Contribution of each Member has been reduced to zero;
  - (b) Next, 100% to Key Developer until such time as Key Developer has received aggregate distributions equal to 10% of all distributions made pursuant to Section (a) and this Section (b); and
  - (c) Thereafter, 90% to Investor and 10% to Key Developer
- Risk to Key Developer: that the LLC will not make enough profit to allow for full payment of catch-up distributions

Example: Catch-Up Distribution



- LLC liquidates and has $2,000,000 of sales proceeds to distribute
  - First, Investor receives $1,000,000 as a return of its capital contribution
  - Next, Key Developer receives $111,111 (catch-up)
  - Thereafter, Investor receives $800,000 (90%) and Key Developer receives $88,889 (10%)
- Investor received $1,800,000 of distributions (90%)
- Key Developer received $200,000 of distributions (10%)

New Carried Interest Legislation

- Generally, the character of income recognized by a partnership flows through to its partners
  - Example: LLC sells a capital asset held for more than 1 year, long-term capital gain flows through to its members
- 2017 Tax Act provides for special rules for certain carried interests, promote interests and profits interests
  - Capital assets must be held for more than 3 years to be treated as long-term capital gain *with respect to applicable carried interests* (but not capital interests)
  - Also, applicable carried interests must be held for more than 3 years to qualify for long-term capital gain treatment upon their sale
- Does not appear to apply to dispositions of certain real estate
  - Certain real estate is "1231 property" not a "capital asset", even though gain from sale of 1231 property is taxable as capital gain
  - Under a strict reading of the statute, the 3 year rule does not apply
- No grandfather provision for existing partnerships
- Legislation is ambiguously drafted and many questions remain

Issue: Allocation of Gain In Lieu of Fees

“I am a developer and I am going to participate in this new partnership. I’m going to receive $500,000 in fees, but I also have to contribute $300,000 to the partnership.”

Solution: Allocation of Gain In Lieu of Fees

- Developer should consider restructuring the arrangement
  - As proposed, $500,000 in fees would be taxable as ordinary income
- Instead, Developer could waive $300,000 of the fee and have it treated as a "deemed capital contribution"
  - Developer would not receive $300,000 of the fee, but would also not have to make a $300,000 contribution
- Developer *might* convert $300,000 of ordinary income (from fee) into $300,000 of capital gain (from sale of project)
- Upon a major capital event, developer would be allocated the first gain, in an amount equal to its deemed capital contribution
  - In our example, upon a sale of the project, the developer would be allocated $300,000 of gain before any other partner received an allocation
- Risk for developer: there is not enough gain from sale of project
  - To the extent there is not enough gain to be allocated to the developer, the amount distributable to the developer must be reduced, dollar for dollar
  - Thus, developer would not receive entire $500,000 payment

Issue: Phantom Income

"I'm a developer. My investor is going to contribute $10 million and we're going to develop property into lots for sale. There also will be $20 million of development financing. The term sheet provides that the investor will get its $10 million back and then we will split all the profits 50/50. How will taxable income be allocated?"

Example: Phantom Income

- Income will be allocated 50/50 between the developer and investor
  - Even during the periods of time when all cash is being used to pay debt service and/or distributions to investor representing a return of his $10 million capital contribution
- As a result, developer would be allocated income in the early years of the partnership without receiving a corresponding, or any, distribution of cash
  - Example: In year 3, the partnership has $2 million in cash flow and $2 million in income
  - Investor:
    - $1 million income allocation
    - $2 million cash distribution
  - Developer:
    - $1 million income allocation
    - $0 cash distribution
  - Developer would have a tax liability of approximately $370,000 and no cash to pay it

Issue: Phantom Income

“I don’t want to receive allocations of income without receiving cash.”

Solution: Tax Advance or Distribution

- To ensure that developer receives cash to pay the taxes on its allocation of income, include a tax advance or distribution provision
  - Whether payment is treated as a distribution or advance is a business point
- Tax distributions are true distributions in the waterfall
- Tax advances are not included in the waterfall
  - Advances on future distributions, decreasing future distributions dollar for dollar
- Generally, neither tax advances or distributions should apply on liquidation of partnership
- Lenders often allow tax distributions or advances, but make sure the partnership provisions are consistent with loan documents
- Provisions to consider
  - Include state and local taxes, if applicable
  - Take character of income (capital gains or ordinary income) into account
  - Take prior losses into account
  - Take other distributions during the tax year into account
  - Clawback of over-advances upon liquidation of the partnership

Issue:
Sale of Property to Development Entities

"I have land that's been in the family for generations. It's worth a whole lot of money but I'm told I can make even more money if we develop it into residential and commercial tracts. I've had a developer approach me and propose that I contribute the property at its current fair market value and that will be my capital contribution and I'll have a priority return on that capital contribution. Then the venture will develop the property and sell the commercial and residential lots and I'll make a fortune. I need for you to structure a joint venture agreement that provides for my capital contribution of property worth $45 million where I get the value of my property back first and then we split the profits 50/50."

Solution:
Sale of Property to Development Entities

- If the property is contributed, the original owner would be foregoing capital gains now for ordinary income later
  - Property owner would not receive any cash upon contribution
  - When partnership sells lots, sales would result in ordinary income
  - Even to the extent attributable to the appreciation in value of the property before contribution
- Solution: sell the property to the partnership, instead of contributing
  - Property owner can lock-in capital gains, based on the property's appreciation
    - Should get an appraisal and obtain highest price possible
  - Any gains from the sale of lots by the partnership would still be ordinary income
- Trap: original owner cannot own more than 50% of the partnership
  - Sale of property is ordinary income when:
    - Property is not a capital asset in the hands of the purchasing partnership, and
    - Sale is by person that owns, directly or indirectly, more than 50% of the capital or profits interests of the purchasing partnership

Issue:
Sale of Property to Development Entities

"What if the developer puts in capital, the partnership buys the land, he gets return of that capital and then I get 60% of the profits thereafter?"

Solution:
Sell to an S Corporation

- The original property owner cannot sell the property to the partnership and recognize capital gain
  - Because he owns more than 50% of the profits interests of the partnership, the sale would result in ordinary income
- Original owner could form an S corporation and sell the property to it, recognizing capital gain
  - Original owner would own 100% of S corporation, which could then contribute the property to the partnership for development
- The 50% ownership rule does not apply when an individual sells the property to an S corporation
  - Even if the S corporation has identical ownership to the ownership of the property
  - Note: partnerships that own property can also sell to S corporations (even with identical ownership) and recognize capital gain

Issue:
Sale of Property to Development Entities

"What if I just want to develop the property myself so that I get 100% of the profit?"

Solution:
Sell to an S Corporation

- If the original owner developed the property himself and sold lots, he would recognize ordinary income
  - Even to the extent attributable to the appreciation in value of the property before contribution
- Original owner could form an S corporation and sell the property to it, recognizing capital gain
  - 50% ownership rule does not apply on a sale to an S corporation
- S corporation would then develop the property and sell lots
  - Sale of lots would still result in ordinary income

Issue: Disguised Sale

"I want to contribute property to my partnership. Once I do, the partnership is going to borrow money and then distribute cash back to me."

Disguised Sale

- This is probably treated as a disguised sale of property by the partner to the partnership
  - Generally, if a partner contributes property to a partnership and within 2 years receives a distribution, the disguised sale rules presume that the transaction was part of a taxable sale
- Exception: debt-financed distributions
  - Traceable to partnership borrowing and the amount of the distribution does not exceed the contributing partner's share of the debt
  - All debt is treated as nonrecouse for purposes of determining a partner's share
    - Contributing partner cannot guarantee the debt to increase its share and avoid disguised sale treatment
- Exception: reimbursement of preformation capital expenditures
  - Reimbursement for certain capital expenditures made within 2 years before the contribution of the property to the partnership are generally not disguised sales

Issue: Partnership Audit Rules

"I'm purchasing the interests of a partnership which owns a project, rather than the project itself. What happens if the partnership has tax liabilities from before I acquire it?"

Partnership Audit Rules

- All partnership audits and tax assessments are implemented at the partnership, not partner, level.
  - The “partnership representative” has sole power (unless limited by contract in the partnership agreement) to deal with the IRS on behalf of the partnership
- When an audit results in an underpayment, the default rule is that the partnership will pay the taxes itself
  - Current partners will effectively bear the tax burden
- A partnership may elect to “push out” the taxes to the partners
  - Election causes partners in the reviewed year (not the current year) to pay taxes, even if they’ve left the partnership
- Purchase agreement should contain indemnities from selling partner with respect to pre-closing tax years
  - Consider amending partnership agreement to make “push-out” mandatory

Issue: Like-Kind Exchanges

"My partner and I each own 50% of two partnerships. We want to go our separate ways. I'm going to exchange my interest in partnership A for his interest in partnership B."

Like-Kind Exchanges

- The exchange of partnership interests would be a taxable transaction for each partner
- Under the 2017 Tax Act, only real property is eligible for like-kind exchanges
  - Partnership interests are not treated as real property, even if the partnership solely holds real property
  - Before the 2017 Tax Act, partnership interests were expressly excluded from like-kind exchanges
- Partnerships may utilize like-kind exchanges when disposing of real property

Issue: Opportunity Zones

“I understand my property is located in an area that might be an ‘opportunity zone.’ How does that help me?”

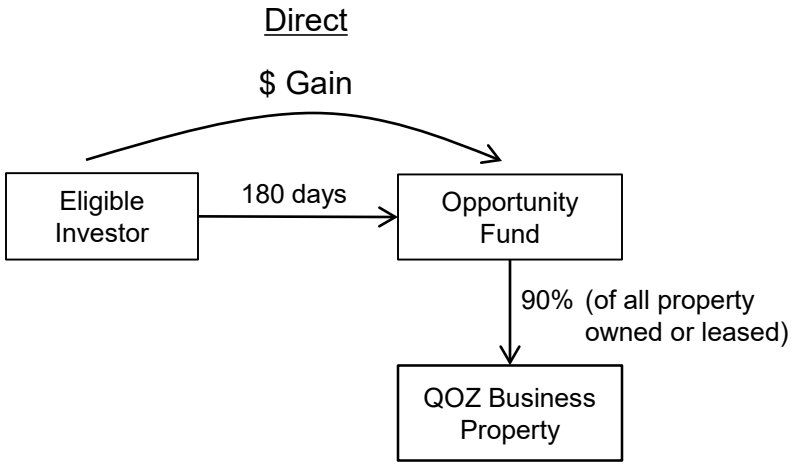
Opportunity Zones

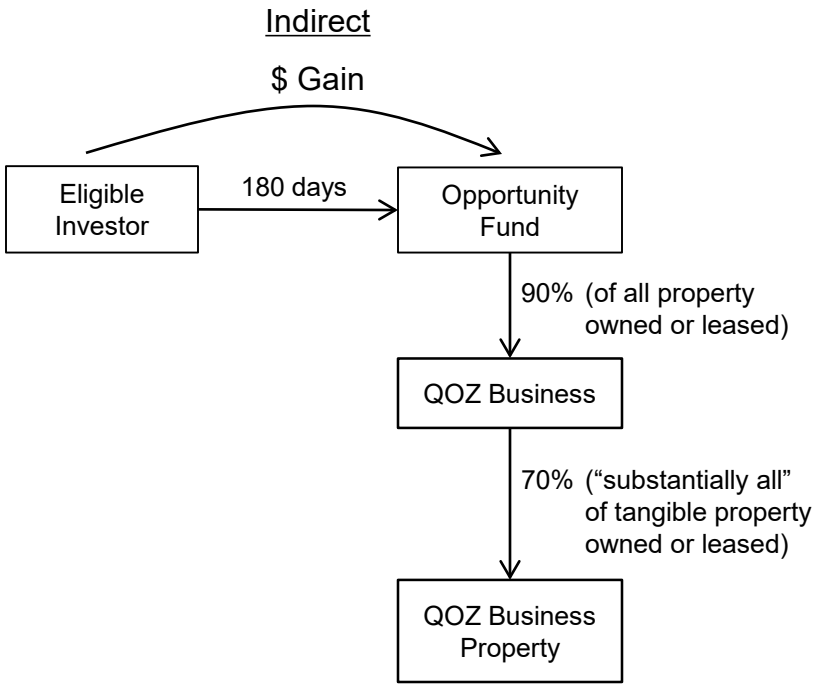
- The 2017 Tax Act created the opportunity zone program to encourage investment in low-income communities
  - Tax benefits may make it easier to raise money from investors
- Eligible Investors must reinvest eligible gains in a qualified opportunity fund within 180 days
- Eligible Investors
  - Any person that recognizes capital gain for tax purposes
- Eligible Gains
  - Any gain taxable as capital gain, including long-term, short-term and 1231 gain
- Qualified Opportunity Fund
  - A partnership or corporation that self-certifies as a qualified opportunity fund on an IRS Form 8996
  - 90% of total assets (owned or leased) are qualified opportunity zone property
  - Qualified opportunity zone property means QOZ business property (tangible property used in a trade or business in a QOZ) and QOZ business interests (stock and partnership interests)

Opportunity Zones

- Benefits
  - Capital gain that is invested in an OZ fund or business is not taxed until the disposition of the investment or 2026, if earlier.
  - 10% of the original gain avoids tax if held 5 years, 15% if held 7 years
  - Future appreciation of the investment is not taxable at all, if held for 10 years
- Example
  - Taxpayer sells stock on January 1, 2019 for $2 million capital gain. Invests the $2 million in an OZ fund within 180 days.
  - If taxpayer sells interest in the OZ fund on December 31, 2029 for $3 million:
    - No tax on the $2 million of capital gain until December 31, 2026
    - 15% of the original $2 million capital gain is excluded from tax
    - The additional $1 million of gain from the 2029 sale is excluded from tax

Opportunity Zones





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The SECURE Act – Planning implications for high net worth individuals

TAX ALERT | December 20, 2019

On Dec. 19, 2019, Congress passed the Setting Every Community Up for Retirement Enhancement Act, known as the SECURE Act, as part of the appropriations bills that will fund the federal government through September 2020. The President is expected to sign the SECURE Act into law. This summary focuses on the financial and estate planning implications of the SECURE Act for high net worth individuals. For a summary that focuses on the Act's potential implications for employers and plan sponsors, see SECURE Act Impacts Employer Plans

From the perspective of the high net worth individual, there are three provisions that could call for attention sooner rather than later.

First, individuals can contribute to traditional Individual Retirement Accounts (IRAs) after age 70½. With many people trying to stay in the workforce longer, that is probably a good thing.

Second, the Act delays required minimum distributions (RMDs) from traditional IRA's and other qualified plans from age 70½ to 72. Unfortunately, for those who are on the cusp of taking their first RMD, this provision only applies to individuals who turn 70½ after Dec. 31, 2019. Still, when the delay in RMDs is taken together with proposed regulations that eectively, albeit slightly, reduce the amount of each RMD at a given age, individuals will be able to keep a little more money in those accounts for a little longer than under current law. As many individuals and their planners are aware, RMDs is among the more complex (and perplexing) topics in the tax law. This relatively straightforward description of the change to the start year for RMDs belies the complexity that the change will add to this topic.

Third, the Act will in many cases, eliminate the opportunity under current law to 'stretch' RMDs over a beneficiary's life expectancy. The Act will force a beneficiary of a plan, including a Roth IRA, to withdraw the entire balance of the account within 10 years after the owner's death. There is no mandated annual RMD. Just be sure the money is out by the 10th year. Importantly, the Act aects the RMDs from a Roth, not the tax-free character of those withdrawals. There are important exceptions to the 10-year rule. A beneficiary who is the deceased owner's surviving spouse, or a minor child of the owner, or a disabled or chronically ill individual, or any other individual who is not more than 10 years younger than the owner, can still 'stretch' the RMDs over his or her life expectancy, though once the minor reaches majority, the 10-year rule comes in to play. This provision applies to owners who pass away after Dec. 31, 2019.

At first blush, this third provision is the most significant of the three from a planning perspective. However, the following example posed first under the current rules and then after the SECURE Act, suggests that it could be only of significance to a relatively small subset of the demographic.

An individual, whom we will call Matt, has $1.5 million in a traditional IRA. Matt has designated his wife Maura as beneficiary of the IRA. Matt turned 70½ this year and plans to take his first RMD by April 1, 2020. An important part of this story, and a key indicator of the significance of this new provision to any individual, is that Matt does not need the money that he will withdraw from the IRA. Therefore, he will take only the required amount and no more. Matt dies at age 75, survived by Maura, who is then 74. Maura rolls the IRA over to her own name and designates their daughter Maureen, age 40, as her beneficiary. Maura takes her RMDs in a timely fashion, again limiting the withdrawal to the amount required. She dies at 87. As long as Maureen begins taking RMDs within a year after her mother died, she can 'stretch' the account withdrawals over her then expected remaining lifetime. At an assumed return of 7% from her father's age 70½ and RMDs limited to the required amount, the account would finally be depleted at Maureen's projected life expectancy of age 84.

We should digress for a moment to note that many owners of large IRAs prefer to have them payable to trusts for their children that will preserve the funds from their children's creditors (as well as their children's improvidence) but still maintain the stretch. These individuals can use so-called 'see-through' trusts that will take the RMDs per the appropriate table and either just pay them out every year to the children/beneficiaries, a conduit trust or hold those RMDs in the trust for subsequent discretionary distributions, an accumulation trust.

Returning to the example, the SECURE Act would not change anything as far as Matt and Maura are concerned because the 10-year payout requirement does not apply to a surviving spouse. However, Maureen would no longer be able to stretch the withdrawals over her lifetime. The money would have to come out of the account within 10 years after her mother passed away. Assuming that 7% return and annual withdrawals equal to those taken in the first example, there would be approximately $2.74 million in the account at that time. If Maureen decides to leave the money in the account until it has to be withdrawn in the 10th year, there would be $3.762 million. It is not a stretch to assume that this is not the kind of planning that Matt and Maura had in mind. It is also likely to be more than a blip on Maureen's radar screen as well.

Still, we have to keep the significance of this in perspective. As typical as this scenario may be in a high net worth setting, the reality is that many people who have these accounts will not be affected by or care at all about the loss of the stretch by their children. Again, their surviving spouses will still be able to spread the withdrawals over their lifetimes. Moreover, even if that is the case, they might have to take well more than the RMDs to live, thereby spending the accounts down over their lifetimes, if not before. In other words, the notion that there will be anything left is, well, a 'stretch'. It is also quite possible that they think that if there is something left for the kids, a 10-year stretch is just fine.

Individuals whose plans, whether as taxpayers or as parents, are going to be significantly impacted by curtailment of the stretch IRA do have some things to consider and some options to explore:

- Individuals who currently plan to leave the IRA to a trust for the benefit of their children should consult with their tax advisors now. Their advisors can explain just how the Act will apply to their particular situation and, if necessary, what options they have for revamping the plan to be sure it aligns with their personal and tax objectives.
- Consider using Roth conversions to avoid RMDs for at least for one generation (the spouses/parents) so that the IRA can grow without diminution from those withdrawals and then the RMDs will come out to the

children tax-free, albeit much faster than they anticipated. Individuals should ask their tax advisors to 'run the numbers' to see if paying the tax on conversion (preferably with money from outside the IRA) makes sense.

- Charitably inclined individuals may now have even more incentive to leave their traditional IRAs to charity. The IRA is 'income in respect of a decedent', which means that it is included in the owner's taxable estate and income taxable to the beneficiary as the funds are withdrawn. For these reasons, charitably inclined individuals have long chosen to leave IRAs to charity and leave assets more favorably taxed at death to their children.
- A variation on the theme of charitable giving with the IRA is to leave it to a testamentary charitable remainder trust that would provide an income stream to the children for a certain term and then pass to charity. This technique would eliminate RMDs altogether. What's more, the estate would be entitled to a deduction for the present value of the remainder projected to pass to the charity at the end pf the term.
- Use life insurance in lieu of the IRA. We do not mean to do that literally. We do mean that the individual would perhaps accelerate RMDs and direct the after-tax balance to an irrevocable life insurance trust (ILIT). The ILIT will have no RMDs. Of course, having estate tax free life insurance could be helpful in any event to provide liquidity for estate taxes, particularly on any significant IRA balances that pass to the children upon their parents' death.

We will have more to say about the SECURE Act in future publications. For now, we urge individuals to consult promptly with their advisors about how these changes might affect their financial and estate planning.

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SECURE Act impacts employer plans

TAX ALERT | December 20, 2019

On Dec. 19, 2019, Congress passed the Setting Every Community Up for Retirement Enhancement Act, known as the SECURE Act, as part of the appropriations bills that will fund the federal government through September 2020. The President is expected to sign the SECURE Act into law. The SECURE Act makes a number of important changes affecting retirement benefits in qualified retirement plans and in IRAs for both the employers that sponsor qualified retirement plans and for individuals who participate in such plans and in IRAs. This SECURE Act summary focuses on the Act's potential effect on employers and plan sponsors. Read a summary of the SECURE Act's effects on individuals.

The SECURE Act changes that potentially affect employers and plan sponsors include:

Increase the age of required minimum distributions

The SECURE Act increases from 70½to 72 the age at which individuals participating in a qualified retirement plan or IRA must commence required minimum distributions. This change takes into account the increase in life expectancies since the required minimum distribution rules were originally enacted. Plans are not required to make mandatory distributions until the year after the year in which a participant attains age 72.

This provision is effective for distributions required to be made after Dec. 31, 2019 for plan participants and IRA owners who reach the age 70 ½ after Dec. 31, 2019. The Internal Revenue Service is expected to provide guidance on when qualified retirement plans must be amended for this change.

Repeal of the maximum age prohibition for IRA contributions

The SECURE Act repeals the prohibition on individuals who turn 70 ½ from contributing to a traditional IRA. This provision is effective for contributions made for tax years beginning after Dec. 31, 2019.

Changes to lifetime income options

The SECURE Act now permits the transfer of a lifetime income investment contract from one defined contribution plan to another defined contribution plan, or to an IRA, by direct trustee-to-trustee transfer in the event that the transferring plan no longer authorizes the investment contract. The Act's addition of a new permissible distributable event allows participants to keep their investment contract and avoid surrender charges. A lifetime income investment is a form of plan benefit paid over the life expectancy of a plan participant

or over the life expectancies of a participant and beneficiary (e.g. an annuity contract). This provision is effective for plan years beginning after Dec. 31, 2019.

The SECURE Act also includes a safe harbor for plan fiduciaries in selection of insurer for a guaranteed retirement income contract. Lifetime income disclosure statements are now required once during any 12-month period. The SECURE Act directs the Secretary of Labor to develop a model disclosure with the required information.

Part-time employees included in retirement plans

The SECURE Act now prohibits employers from excluding part-time employees from participation in the employer's defined contribution plan, provided that such employees have been credited with at least 500 hours of service per year for at least three consecutive years and reached the age of 21 by the end of the three-year period. The provision is effective for plan years beginning after Dec. 31, 2020.

Credits for small employer plans

The SECURE Act provides a significant increase in the maximum dollar limit allowed for the tax credit small businesses can use for up to 50% of its qualified costs of setting up a retirement plan. The new dollar limit may be as high as $5,000, up from $500. Additionally, the Act provides a tax credit of up to $500 per year to employers that include automatic enrollment in their 401(k) plans and SIMPLE IRAs. The automatic enrollment tax credit is also available to employers that convert an existing plan to an automatic enrollment plan. Both of these credits are effective for tax years beginning after Dec. 31, 2019.

Increase cap on automatic salary deferral

The SECURE Act increases , from 10% to 15%, the maximum amount of an employee's compensation that can be automatically deferred under a plan with an automatic enrollment safe harbor, beginning after the employee's first plan year. This provision is effective for plan years beginning after Dec. 31, 2019.

Modification on what type of payments are considered compensation for IRA purposes

The SECURE Act provides that the amount of stipends and non-tuition fellowship payments received by graduate and postdoctoral students will be considered as compensation in determining IRA contribution limitations. This provision is effective for taxable years beginning after Dec. 31, 2019.

Additionally, "difficulty of care payments" to healthcare workers will also be considered compensation for determining retirement contribution limitations under the SECURE Act. This provision is effective the date of enactment with a special provision for certain defined contribution plans for plan years beginning after Dec. 31, 2015.

Changes to multiple employer plans

The SECURE Act amends the Internal Revenue Code to revise requirements for multiple employer pension plans and pooled plans. The "bad apple" rule, which provides that if one employer in a multiple employer retirement plan fails then the entire plan fails, has been eliminated. The changes to multiple employer plans requirements also make it easier for employers who are not in a common industry to form "pooled" retirement plans.

Changes to Safe Harbor 401(k) Rules

The SECURE Act now permits a mid-year amendment to the non-elective employer contribution percentage for the plan year under a safe harbor 401(k) plan, provided that the amendment occurs before the 30th day before the close of the plan year. An amendment made within 30 days before the plan year close is still allowed, but only if the amendment provides for a non-elective contribution of at least 4% of compensation for all eligible employees and the plan is amended no later than the last day for distributing excess contributions for the plan year. This provision is effective for plan years beginning after Dec. 31, 2019.

Prohibition on making loans through credit cards

Under the SECURE Act, qualified retirement plans are no longer permitted to extend plan loans in the form of a credit card or similar arrangement. The purpose of the provision is to ensure that plan loans are not used for routine or small purchases. This provision is effective for loans made after the date of enactment.

Consolidated Form 5500

Under the SECURE Act, all members of a group of plans are now permitted to file a single consolidated Form 5500 so long as a set of conditions are met. The conditions include: the plans must be defined contribution plans; have the same trustee; the same fiduciary; the same administrator; use the same plan year; and provide the same investments or investment options to plan participants. This provision is effective for returns required to be filed with respect to plan years beginning after Dec. 31, 2019, and annual returns for plan years beginning after Dec. 31, 2021.

Changes to nondiscrimination testing

The SECURE Act modifies the nondiscrimination rules for closed or "frozen" defined benefit pension plans. Closed plans may now permit existing participants to continue to accrue benefits, thus protecting older plan participants.

Extension of time to adopt an employer-sponsored retirement plan

The SECURE Act provides that employers that adopt a qualified retirement plan after the close of a taxable year but before the filing due date may be treated as in effect as of the last day of the taxable year. This provision is effective for plans adopted for taxable years beginning after Dec. 31, 2019.

Additional Changes

The SECURE Act also makes the following changes:

· Provides for the issuance of Treasury guidance on distributions upon the termination of a 403(b) custodial account;

· Clarifies the definition of "church plan" participants;

· Includes an exception from the 10% early distribution rule for distributions on account of a birth or adoption;

· Reinstates certain income exclusion rules for volunteer firefighters and emergency medical responders;

· Expands permissible expenses under a section 529 education savings account; and

· Increases "failure to file" penalties and penalties for failing to file Form 5500.

Employers will need to spend some time reviewing the above changes with their retirement plan advisors to determine the changes needed to plan documents as well as internal company policies and procedures.

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The Written Plan Document Matters—20 Helpful Tips to Avoid Written Plan Document Problems

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The Internal Revenue Service is fairly particular about qualified retirement plans; and for a good reason, which we will talk about below.

This article discusses the written plan document requirement for qualified retirement plans. The first part of the article provides a list of twenty tips to employers to avoid problems with the written plan document requirement for qualified retirement plans. The second part of the article discusses a 2018 Tax Court case that may have lessened the burden on employers to keep up with their written plan documents, and the nearly immediate response by the IRS that took the teeth out of the Tax Court's new "dog ate my homework" defense.

First, here is a little background on why the written plan document requirement is so important. Let's agree that qualified plans include 401(k), 403(b), ESOP, some profit-sharing, and most pension plans. The IRS is concerned about qualified plans for three main reasons. First, qualified plans provide upfront tax deductions to the employer when contributions are made. Second, qualified plans provide deferral of tax to the employee until the time of distribution (and even later with rollovers). Third, qualified plans are exempt from tax on their investment income. The Government calls these three benefits a “tax expenditure," which is a fancy name for an area in which the Government loses money because of a tax benefit provided in the law. Qualified retirement plans collectively account for one of the highest tax expenditures in the economy.

Now, on to Part 1.

Understandably, the IRS expects something in return for these tax expenditures. What the IRS expects is compliance with the requirements of Section 401(a) of the Internal Revenue Code, which is best achieved through the written plan document requirement. Without getting bogged down into too many details, here is a list of twenty tips that an employer may use to help avoid problems with the written plan document requirement:

1. Adopt a written plan document.
2. Have an authorized person sign the written plan document.
3. Read or at least be familiar with the written plan document.
4. Know that the written plan document is important.
5. Make sure that plan fiduciaries know how to get a copy of the written plan document, and talk about the written plan document in administrative committee meetings.

6. Administer the plan the way the written plan document says to.
7. Hire qualified specialists (lawyers, CPAs, and recordkeepers) to help you administer the written plan document.
8. Check periodically to make sure that the administration of the plan aligns with the written plan document.
9. Make sure that recordkeepers are administering the plan in accordance with the written plan document, and not their plan administrative manual or an out of date version of the written plan document.
10. Be sure the written plan document complies with current legal requirements.
11. Know where your company keeps the written plan document.
12. Tell employees about the written plan document.
13. Amend the written plan document when the law changes.
14. Amend the written plan document when you want to change how the plan works.
15. Know and comply with the deadlines for voluntary amendments and compliance amendments.
16. Know that amendments to the written plan document are part of the written plan document.
17. Know that the written plan document is not the same as the summary plan description.
18. Provide the written plan document to employees upon request.
19. Provide the written plan document to the IRS and the DOL when they want to see it.
20. Check with legal counsel before you let your company-wide document retention policy destroy or delete your old written plan documents.

The IRS is very serious about the written plan document. These twenty tips could help avoid a real problem in the future, including the problem that we discuss below in Part 2.

Now on to Part 2 and the problem of Val Lanes' unsigned plan amendment.

In May 2005, the IRS started an examination of the qualified plan of Val Lanes Recreation Center Corporation in West Des Moines, Iowa. The IRS found several issues with the Val Lanes plan, which was an ESOP. One of those problems was the inability to provide the IRS with a copy of the signed USERRA amendment that Val Lanes was required to adopt as a result of legislative changes to the tax qualification requirements.

Because of the unsigned amendment, the IRS proposed to take away favorable tax treatment—called disqualification—of the Val Lanes ESOP plan from 2001 to the present.

USERRA is a very important law because it protects the qualified plan rights of employees who are called to active duty in the U.S. Armed Forces. USERRA was originally adopted in 1994. The IRS provided a model amendment for employers to use to comply with USERRA. The model

amendment is only a few lines long and basically incorporates the wording of the USERRA statute in the adopting plan by reference.

When the IRS audited the Val Lanes' qualified plan, it asked for all of the signed amendments to the written plan document and was provided with an unsigned copy of the USERRA amendment. A signed copy of the USERRA amendment could not be found. The problem for Val Lanes was how to satisfy the IRS requirement that the USERRA amendment had been timely signed.

The dispute about the missing amendment went through the IRS administrative procedures and ended up in the Tax Court case called Val Lane Recreation Center Corporation v. Commissioner, which was finally decided in 2018. You can read the case at this link https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=11686

The Tax Court concluded that Val Lanes had put on credible testimony that allowed it to conclude that the USERRA amendment must have been signed timely and that the IRS had abused its discretion in proposing to disqualify Val Lanes' qualified plan. The evidence that the Tax Court found favorable included: testimony by Val Lanes' CPA that he remembered that the USERRA amendment had been signed; testimony from the owner of Val Lanes that he always signed whatever the CPA sent him to sign; further testimony of the owner that his office experienced flood damage and many documents were lost or destroyed; and finally, the testimony of another witness that the IRS and DOL had seized the CPA's records in a separate proceeding and had not returned them.

Needless to say, the Tax Court's decision in Val Lanes was an important win for the taxpayer and plan sponsors generally. All of a sudden, it seemed that the Tax Court had recognized a new Beaver Cleaver defense to the written plan document requirement.

This new holding worried the IRS, which in December 2019 issued a Chief Counsel Memorandum that took the teeth out of the "**dog ate my homework**" defense. You can read the Chief Counsel Memorandum at this link https://www.irs.gov/pub/foia/am-2019-002.pdf According to the IRS, it intends to continue to pursue disqualification when employers are unable to provide signed copies of the written plan document, including required amendments.

All is not lost for employers with incomplete written plan document files. The IRS will help employers avoid disqualification due to late or missing amendments through the EPCRS correction program in Revenue Procedure 2019-19, which you can read at this link https://www.irs.gov/pub/irs-drop/rp-19-19.pdf In addition, the IRS adopted a policy in 2001 called "Verification of Prior Plan Documents in the Absence of a Determination Letter." That policy is no longer on the IRS website, but you can find a copy at this link. https://benefitslink.com/src/irs/ep-qual-assurance.pdf. To the extent the IRS still follows the 2001 policy or its principles, some additional relief may be available to employers with written plan document problems.

In conclusion, employers should take the written plan document requirement very seriously, and the twenty tips offered here should help employers stay on the right side of the compliance line. The Val Lanes case may provide some relief to employers who are experiencing written plan document requirement problems in appropriate cases. However, the IRS is prepared to pursue harsh sanctions against employers that have late or missing written plan documents.

Employers should consider seeking professional advice for any questions about the written plan document requirement and how to protect themselves through effective administrative compliance policies and the EPCRS.

TAX SECTION
State Bar of Texas

February 17, 2020

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

CC:PA:LPD:PR (REG–122180–18)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: ***Comments Regarding Proposed Regulations on Certain Employee Remuneration in Excess of $1,000,000 under Internal Revenue Code Section 162(m)***

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 the proposed rulemaking in Certain Employee Remuneration in Excess of $1,000,000 Under Internal Revenue Code Section 162(m), 84 Federal Register 70356, published in 84 Fed. Reg. 70356–70391 (December 20, 2019), adding certain proposed regulations (the "Proposed Regulations") under section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code").

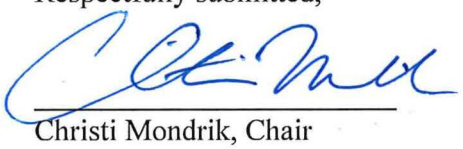
1414 Colorado Street, Austin, TX 78701
(512) 427-1463 or (800) 204-2222

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. We specifically request that Henry Talavera, on behalf of the Tax Section, be permitted to participate in the public hearing scheduled for March 9, 2020, to discuss the topic raised below. Mr. Talavera is simultaneously providing a brief outline as part of this comment submission.

Respectfully submitted,



Christi Mondrik, Chair
State Bar of Texas, Tax Section

Enclosure

COMMENTS ON PROPOSED REGULATIONS ADDRESSING CERTAIN EMPLOYEE REMUNERATION IN EXCESS OF $1,000,000 UNDER SECTION 162(m) OF THE CODE

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 Jessica S. Morrison, Vice-Chair of the Employee Benefits Committee of the Tax Section, and Henry Talavera, Treasurer of the Tax Section; Rafael Ramos Aguirre assisted with drafting these Comments.[1] The Committee on Government Submissions of the Tax Section has approved these Comments. James Griffin, Chair of the Employee Benefits Committee of the Tax Section, and Mark A. Bodron, member of the Tax Section, 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: February 17, 2020

[1] Mr. Aguirre is an associate in Mr. Talavera's law firm, though he is not a member of the State Bar of Texas.

I. INTRODUCTION

These Comments are provided in response to the request of the Treasury Department and the Service for comments regarding the Proposed Regulations addressing certain employee remuneration in excess of $1,000,000 under section 162(m) of the Code, as amended by section 13601 of Public Law 115-97 (the "Act"). We appreciate the opportunity to comment on the Proposed Regulations.

II. SUMMARY

We are commenting on only one topic: the meaning of "negative discretion" under the "grandfather" rule of the Act. We respectfully recommend that the Service clarify that a compensation committee of the board of directors of a corporation or other responsible body ("Compensation Committee") will not be deemed to have the right to exercise negative discretion solely because the applicable plan or other document governing an award (the "plan") had a provision in effect on or prior to November 2, 2017, giving negative discretion to the Compensation Committee to reduce the amount of compensation that the corporation is obligated to pay, but will only not be deemed to have that right if the following was also accurate as of such date:

> Such negative discretion was limited by one or more provisions in the plan that (when read together) required (or in all material respects required) compliance with the requirements for the payment of qualified performance-based compensation under section 162(m) of the Code.

In such case and consistent with applicable state law, we respectfully suggest that the Compensation Committee should not be considered to have a right to exercise negative discretion. Therefore, any provision purporting to give such negative discretion (without further action of the Compensation Committee) should be disregarded in determining the amount of compensation that a corporation is obligated to pay pursuant to a written binding contract.

III. WE SUGGEST THAT A PLAN PROVISION REQUIRING COMPLIANCE WITH SECTION 162(m) SHOULD EFFECTIVELY LIMIT NEGATIVE DISCRETION OTHERWISE PROVIDED FOR BY A PLAN.

Section 13601(e) of the Act provides that amendments made by the Act to section 162(m) of the Code "shall not apply to remuneration which is provided pursuant to a written binding contract which was in effect on November 2, 2017, and which was not modified in any material respect on or after such date." This "grandfather" rule is further described in Proposed Regulation § 1.162-33(g)(1)(i), which provides:

> Remuneration is a grandfathered amount only to the extent that as of November 2, 2017, the corporation was and remains obligated under applicable law (for example, state contract law) to pay the remuneration under the contract if the employee performs services or satisfies the applicable vesting conditions.

In the Preamble to the Proposed Regulations, the Service specifically addresses the application of this rule to compensation subject to negative discretion:

> Under the definition of written binding contract in Notice 2018–68 and these proposed regulations, applicable law (such as state contract law) determines the amount of compensation that a corporation is obligated to pay pursuant to a written binding contract in effect on November 2, 2017. Some commenters suggested that negative discretion be completely disregarded in determining the amount of compensation that a corporation is obligated to pay pursuant to a written binding contract. The proposed regulations do not adopt this approach, because it is contrary to the statutory text and the legislative history. See House Conf. Rpt. 115–466, 490 (2017). The Treasury Department and the IRS are aware, however, that compensation arrangements may purport to provide the corporation with a wider scope of negative discretion than applicable law permits the corporation to exercise. ***In that case, the negative discretion is taken into account only to the extent the corporation may exercise the negative discretion under applicable law***.

Preamble to Proposed Regulations, 84 Fed. Reg. 70365 (emphasis added).

The Proposed Regulations also include an example illustrating the negative discretion concept in Proposed Regulation § 1.162-33(g)(3)(xvi) ("*Example 16*"*)*, which provides:

> *Example (16).* (Performance bonus plan with negative discretion).
>
> (A) *Facts.* Employee E serves as the PEO of Corporation V for the 2017 and 2018 taxable years. On February 1, 2017, Corporation V establishes a bonus plan, under which Employee E will receive a cash bonus of $1,500,000 if a specified performance goal is satisfied. The compensation committee retains the right, if the performance goal is met, to reduce the bonus payment to no less than $400,000 if, in its judgment, other subjective factors warrant a reduction. On November 2, 2017, under applicable law which takes into account the employer's ability to exercise negative discretion, the bonus plan established on February 1, 2017, constitutes a written binding contract to pay $400,000. On March 1, 2018, the compensation committee certifies that the performance goal was satisfied, but exercises its discretion to reduce the award to $500,000. On April 1, 2018, Corporation V pays $500,000 to Employee E. The payment satisfies the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation.
>
> (B) *Conclusion.* If this §1.162-33 applies, Employee E is a covered employee for Corporation V's 2018 taxable year. Because the February 1, 2017, plan is a written binding contract to pay Employee E $400,000 if the performance goal is satisfied, this section does not apply (and §1.162-27

> does apply) to the deduction for the $400,000 portion of the $500,000 payment. Furthermore, the failure of the compensation committee to exercise its discretion to reduce the award further to $400,000, instead of $500,000, does not result in a material modification of the contract. Pursuant to §1.162-27(e)(1), the deduction for the $400,000 payment is not subject to section 162(m)(1) because the payment satisfies the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation. The deduction for the remaining $100,000 of the $500,000 payment is subject to this section (and not §1.162-27) and therefore the status as qualified performance-based compensation is irrelevant to the application of section 162(m)(1) to this remaining portion.

84 Fed. Reg. 70389.

We suggest that this *Example 16* does not provide sufficient guidance to corporations; as a result, this *Example 16* can perhaps be interpreted to "un-grandfather" many plans that should be grandfathered because in practice there is not unlimited and impermissible negative discretion as contemplated by the Service. In these Comments, we address a common type of provision that, in our experience, exists in many plans. We respectfully suggest that negative discretion (and whether it can be exercised) should be determined based upon the overall provisions of a plan and not simply a provision (out of context) that may appear to grant full and complete "negative discretion" to a Compensation Committee.

We note that provisions granting negative discretion to a Compensation Committee have been used and adopted widely by plans. We suggest that this is likely because Treasury Regulation § 1.162-27(e)(2)(iii) expressly provided that the Compensation Committee, in compliance with the requirements under section 162(m) of the Code for the payment of qualified performance-based compensation (the "Section 162(m) Requirements"), may retain the discretion to eliminate or reduce an amount of compensation or other economic benefit that was due upon attainment of a performance goal.

We respectfully suggest that the extent of any "negative discretion" should be determined based on all of the underlying documentation and provisions related to a plan, including, but not limited to, provisions that limit a Compensation Committee's ability to exercise any negative discretion. Just as negative discretion is widely used and useful in compensation plan design, it has been very common in our experience for plans also to include provisions that require a Compensation Committee to comply with the Section 162(m) Requirements as a precondition for the payment of amounts intended to be qualified performance-based compensation. Indeed, publicly traded corporations often represent in applicable SEC filings that compliance with the Section 162(m) Requirements will be achieved. Even if a plan does not expressly limit any negative discretion, in such context the Compensation Committee can never exercise its negative discretion in a manner that would violate the Section 162(m) Requirements without violating the express terms of other plan provisions.

We suggest that all of the provisions of a plan should be read in context. As the Second Restatement of Contracts provides, "[a] writing is interpreted as a whole, and all writings that are part of the same transaction are interpreted together." Restatement (Second) of Contracts § 202(2). The Texas Supreme Court has stated that, "[i]n construing a written contract, the primary concern of the court is to ascertain the true intentions of the parties as expressed in the instrument," and "[t]o achieve this objective, courts should examine and consider *the entire writing* in an effort to harmonize and give effect to *all the provisions* of the contract so that none will be rendered meaningless." *Coker v. Coker*, 650 S.W.2d 391, 393 (Tex. 1983). Further, "[n]o single provision taken alone will be given controlling effect; rather, all the provisions must be considered with reference to the whole instrument." *Id.*

If the Proposed Regulations are not revised to require a holistic interpretation of all provisions of a plan in this context, it is possible that a negative discretion provision as outlined in the Proposed Regulations would lead to the retroactive and automatic loss of grandfathered status of many plans. A plan provision that, taken out of context, appears to provide discretion to a Compensation Committee to reduce an award to zero (or any other amount), does not necessarily give a Compensation Committee unfettered discretion to make such a reduction.

As described above, in many cases, such discretion is effectively limited by provisions of a plan that mandate compliance with the Section 162(m) Requirements. In such a circumstance, we respectfully suggest that any awards in place on November 2, 2017, that require compliance with Section 162(m) Requirements became binding pursuant to such requirement and state law once the Act required that a binding contract be in place on that date in order for the Section 162(m) Requirements to remain satisfied after that date. As long as the Compensation Committee did not (and does not) actually exercise such negative discretion in a manner contrary to other plan provisions that mandate compliance with the Section 162(m) Requirements, then we suggest that grandfathered status should not be lost.

We also suggest that incorporation of the Section 162(m) Requirements into a plan should be viewed in light of the broad interpretive authority that, in our experience, most plans give the Compensation Committee. A Compensation Committee's typically broad authority to interpret a plan arguably permits it to disregard a negative discretion provision that, when read in context with other plan provisions requiring compliance with the Section 162(m) requirements, should have no effect after November 2, 2017, so that the plan should remain grandfathered. In other words, if the Compensation Committee interprets the plan as providing a binding promise, we respectfully suggest that the Service should respect that this interpretation governs absent facts and circumstances to the contrary.

The approach advanced in these Comments is consistent with provisions of the Code requiring "binding" rights in other contexts. In particular, the regulations under section 409A of the Code provide the following:

> A service provider does not have a legally binding right to compensation to the extent that compensation may be reduced unilaterally or eliminated by

> the service recipient or other person after the services creating the right to the compensation have been performed. However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition, ***or the discretion to reduce or eliminate the compensation lacks substantive significance***, a service provider will be considered to have a legally binding right to the compensation. Whether the discretion to reduce or eliminate the compensation lacks substantive significance depends on all the relevant facts and circumstances."

Treas. Reg. § 1.409A-1(b)(1) (emphasis added).

We respectively suggest that negative discretion lacks substantive significance in circumstances in which such negative discretion is limited by the Section 162(m) Requirements (i.e., in situations in which a Compensation Committee's exercise of negative discretion after the enactment of the Act effectively would cause amounts to be non-deductible).

Further, a contract may be presumed to be a "binding agreement" even if all of the terms of such contract are not fixed. The Second Restatement of Contracts provides that "the actions of the parties may show conclusively that they have intended to conclude a binding agreement, even though one or more terms . . . are left to be agreed upon," and that "[i]n such cases courts endeavor, if possible, to attach a sufficiently definite meaning to the bargain." Restatement (Second) of Contracts § 33, cmt. b; *see also Fischer v. CTMI, L.L.C.*, 479 S.W.3d 231, 239 (Tex. 2016) (citing the Restatement (Second) of Contracts provision cited above as a guiding principle for determining whether a contract is enforceable under Texas law).

We respectfully recommend that the Proposed Regulations be modified as we describe below to confirm that when a Compensation Committee's ability to exercise negative discretion is effectively limited by one or more provisions that require compliance with the Section 162(m) Requirements, the Compensation Committee will not be considered to have a right to exercise negative discretion because any such exercise of discretion is effectively limited to meet the requirements of the Proposed Regulations and the Act. We respectfully suggest that any other result could effectively eviscerate grandfathered status for many similar plans. Further, we respectfully submit that the position of the Service in *Example 16* is unfair in that there is nothing a corporation or Compensation Committee could have done before November 2, 2017, to protect the corporation (and its shareholders) from this problem that results from a change in the law. We respectfully assert that Congress intended to mitigate this problem with the inclusion of the grandfather rule as discussed above, but the current version of the Proposed Regulations would appear to grandfather relatively few plans. Therefore, in the absence of other facts and circumstances and state law to the contrary, we respectfully recommend that a negative discretion provision should be disregarded in determining the amount of compensation that a corporation is obligated to pay pursuant to an otherwise written binding contract.

We respectfully suggest that Proposed Regulation § 1.162-33(g)(3) be amended to include a revised *Example 16* and an additional example (new *Example 17*) set forth below (our proposed additions to the current provisions are underlined below):

Example (16). (Performance bonus plan with negative discretion).

(A) *Facts.* Employee E serves as the PEO of Corporation V for the 2017 and 2018 taxable years. On February 1, 2017, Corporation V establishes a bonus plan, under which Employee E will receive a cash bonus of $1,500,000 if a specified performance goal is satisfied. The compensation committee retains the right, if the performance goal is met, to reduce the bonus payment to no less than $400,000 if, in its judgment, other subjective factors warrant a reduction, and the bonus plan does not include any provisions that would otherwise require the compensation committee to exercise its discretion in a manner so that bonus payments satisfy the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation. On November 2, 2017, under applicable law which takes into account the employer's ability to exercise negative discretion, the bonus plan established on February 1, 2017, constitutes a written binding contract to pay $400,000. On March 1, 2018, the compensation committee certifies that the performance goal was satisfied, but exercises its discretion to reduce the award to $500,000. On April 1, 2018, Corporation V pays $500,000 to Employee E. The payment satisfies the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation.

(B) *Conclusion.* If this §1.162-33 applies, Employee E is a covered employee for Corporation V's 2018 taxable year. Because the February 1, 2017, plan is a written binding contract to pay Employee E $400,000 if the performance goal is satisfied, this section does not apply (and §1.162-27 does apply) to the deduction for the $400,000 portion of the $500,000 payment. Furthermore, the failure of the compensation committee to exercise its discretion to reduce the award further to $400,000, instead of $500,000, does not result in a material modification of the contract. Pursuant to §1.162-27(e)(1), the deduction for the $400,000 payment is not subject to section 162(m)(1) because the payment satisfies the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation. The deduction for the remaining $100,000 of the $500,000 payment is subject to this section (and not §1.162-27) and therefore the status as qualified performance-based compensation is irrelevant to the application of section 162(m)(1) to this remaining portion.

Example (17). (Performance bonus plan with negative discretion that has been restricted by provision requiring satisfaction of the qualified performance-based compensation requirements).

(A) *Facts.* The facts are the same as in paragraph (g)(3)(xvi) of this section (*Example 16*), except that the bonus plan includes a provision that

requires (or in all material respects requires) the compensation committee to exercise its discretion in a manner so that bonus payments satisfy the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation, and so the compensation committee did not reduce the award and Corporation V paid the full $1,500,000 cash bonus to Employee E.

(B) *Conclusion.* If this §1.162-33 applies, Employee E is a covered employee for Corporation V's 2018 taxable year. Although the bonus plan contained a provision permitting the compensation committee to reduce the bonus payment to no less than $400,000, such discretion was limited by another provision in the bonus plan that in all material respects required compliance with the requirements of §1.162-27(e)(2) through (5) as a precondition for the payment of bonus payments, and in fact, the compensation committee complied with the requirements of §1.162-27(e)(2) through (5) and did not exercise its discretion to reduce the amount. Because the February 1, 2017, plan is a written binding contract to pay Employee E $1,500,000 if the performance goal is satisfied, this section does not apply (and §1.162-27 does apply) to the deduction for any portion of the $1,500,000 payment. Furthermore, the compensation committee's ability alone to exercise its discretion to reduce the award does not result in a material modification of the contract. Pursuant to §1.162-27(e)(1), the deduction for the $1,500,000 payment is not subject to section 162(m)(1) because the payment satisfies the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation.

TAX SECTION OF
THE STATE BAR OF TEXAS

2019 – 2020 CALENDAR

June 2019	
Thurs - Fri 6/13-14/19	**SBOT Annual Meeting** JW Marriott Hotel 110 E 2nd St. Austin, Texas 78701 (512) 474-4777
Wed - Fri 6/12-14/19	**Leadership Academy Austin Session (with Annual Meeting)** Norton Rose Fulbright 98 San Jacinto Blvd, Ste 1100 Austin, Texas 78701 (512) 474-5201
Thursday 6/13/19	**Tax Section Council / Planning Retreat** JW Marriott Hotel Austin, Texas 78701 12:00 p.m. - 3:00 p.m.
Thursday 6/13/19	**2019 Tax Section Annual Meeting Speaker's Dinner** Second Bar + Kitchen 200 Congress Ave, Austin, TX 78701 (512) 827-2750
Thursday 6/13/19	**Presentation of Outstanding Texas Tax Lawyer** Award Presentation at State Bar Annual Meeting, Speakers' Dinner Second Bar + Kitchen 200 Congress Ave. Austin, TX 78701 (512) 827-2750
Friday 6/14/19	**2019 Tax Section Annual Meeting Program** JW Marriott Hotel 110 E 2nd St. Austin, Texas 78701 (512) 474-4777
Friday 6/14/19	**Interview of 2019 Tax Legend** **Presentation During Tax Section Annual Meeting Program** JW Marriott Hotel 110 E 2nd St. Austin, Texas 78701 (512) 474-4777

July 2019	
Thursday 7/4/19	**July 4th Holiday**
Thur - Sat 07/18-20/19	**Texas Bar College** Summer School Moody Gardens Hotel, Spa & Convention Center Seven Hope Boulevard Galveston, TX 77554
?	**Tax Section Budget Deadline** (Budget must be submitted to State Bar of Texas)
Monday 7/29/19	**SBOT Chair and Treasurer Training** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
August 2019	
Thurs – Fri 8/1-2/19	**Advanced Tax Law Course** Hilton Houston Westchase 9999 Westheimer Houston TX 77042 (713) 974-1000
Tuesday 8/6/19	**Officers' Call** 4:00 p.m.
Fri – Sat 8/8-9/19	**Officers' Retreat** Dallas, Texas
Thurs – Tues 8/8-13/19	**American Bar Association Annual Meeting** San Francisco Marriott Marquis, San Francisco, CA
Friday 8/16/19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Friday 8/23/19	**Meeting of Council, Committee Chairs, and Committee Vice Chairs** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 (48th Floor) 10:30 a.m. – 12:30 p.m. w/lunch Dial In: 866-203-7023 Conference Code: 12777252# Security Passcode: None – at the prompt press *

Sept 2019	
?	**Deadline for Submissions to State Bar of Texas Board of Directors Meeting Agenda**
Monday 9/2/19	**Labor Day Holiday**
Wednesday 9/4/19	**Officers' Call** 2:00 p.m.
Monday 9/9/19	**Tax Court Pro Bono Calendar Call-El Paso**
Thurs – Sat 9/12-14/19	**ABA Business Law Section Annual Meeting** Washington DC
Thursday 9/12/19	**Deadline for Chair to Appoint Nominating Committee** (Bylaws 4.10029
Thursday 9/12/19	**Tax Court Pro Bono Calendar Call-Lubbock**
Thursday 09/12/19	**Law School Outreach – Texas Tech School of Law**
Thursday 9/12/19	**Deadline for Appointment of Tax Section Nominating Committee**
Friday 9/13/19	**Submission Deadline – Texas Tax Lawyer (Fall Edition)** Submit to TTL Editor: Michelle Spiegel michelle.spiegel@nortonrosefulbright.com
Thurs - Fri 9/19-20/19	**Leadership Academy Houston Session** **[cancelled due to flooding]**
Friday 9/20/19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Thursday 9/26/19	**Law School Outreach – Texas A&M School of Law**
Sun - Tues 9/29 –10/1/19	**Rosh Hashanah (Religious Holiday)**

Oct 2019	
Thurs-Sat 10/3-5/19	**ABA Tax Section Joint Fall Meeting** San Francisco, CA
Tues - Weds 10/8-9/19	**Yom Kippur (Religious Holiday)**
Wednesday 10/9/19	**Law School Outreach – University of North Texas** 12:00 p.m.
Wednesday 10/9/19	**Officers' Call** 2:00 p.m.
Sun - Sun 10/13-20/19	**Sukkot (Religious Holiday)**
Monday 10/14/19	**Columbus Day Holiday**
Tuesday 10/15/19	**Tax Court Pro Bono Calendar Call –Dallas**
Friday 10/18/19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Tues - Fri 10/22-25/19	**Council on State Taxation (COST) 50th Annual Meeting** JW Marriott, Washington DC
Friday 10/25/19	**Council of Chairs Meeting** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
Fri - Sat 10/25-26/19	**National Association of State Bar Tax Sections ("NASBTS") Annual Meeting** (members may attend at their own expense) Alston & Bird, LLP 950 F Street, NW Washington, DC 20004
Thursday 10/31/19	**Insurance Renewal is Due** **Note Premium Paid by Big Bar!**

Nov 2019	
Friday 11/1/19	**Meeting of Council** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 (48th Floor) 10:30 a.m. – 12:30 p.m. w/lunch Dial In: 866-203-7023 Conference Code: 12777252# Security Passcode: None – at the prompt press *
Monday 11/4/19	**Tax Court Pro Bono Calendar Call-Houston**
Wednesday 11/6/19	**Officers' Call** 2:00 p.m.
Thurs - Fri 11/7-8/19	**Austin Chapter CPA Annual Tax Conference** Norris Conference Center, Austin, Texas
Monday 11/11/19	**Veterans Day Holiday**
Tuesday 11/12/19	**Annual Meeting Deadline for submitting to SBOT date and time preferences for CLE programs, section meetings, council meetings, socials and special events**
Tuesday 11/14-15/19	**Texas Taxpayers and Research Association (TTARA) Annual Meeting** Austin, TX
Friday 11/15/19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Monday 11/18/19	**Tax Court Pro Bono Calendar Call - Dallas**
Tuesday 11/20/19	**Comptroller Annual Briefing** 9 a.m. – 4:30 p.m. Robert E Johnson Legislative Office Building 1501 Congress Ave Austin, TX
Thurs-Fri 11/21-22/19	**International Tax Law Symposium** Houston, TX
Thursday 11/28-29/19	**Thanksgiving Day Holiday**

Dec. 2019	
Monday 12/2/19	**Tax Court Pro Bono Calendar Call-Dallas & San Antonio**
Wednesday 12/4/19	**Officers' Call** 2:00 p.m.
Wed - Thurs 12/4-6/19	**UT Law 66th Annual Taxation Conference** AT&T Conference Center, Austin, Texas
Monday 12/9/19	**Tax Court Pro Bono Calendar Call-Houston**
Friday 12/20/19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Sun - Mon 12/22-30/19	**Hanukkah (Other Holiday)**
Wednesday 12/25/19	**Christmas (Other Holiday)**
Jan. 2020	
Wednesday 1/1/20	**New Year's Day Holiday**
?	**Nomination Period Opens for 2019 Outstanding Texas Tax Lawyer Award** • Nominations due April 1, 2020 • Nomination forms to be posted on website • Submit nomination forms to Tax Section Secretary: Dan Baucum
Wednesday 1/8/20	**Officers' Call** 2:00 p.m.
?	**Deadline for receipt of information for SBOT Board of Directors Meeting Agenda**
Monday 1/6/20	**Annual Meeting Deadline: Submit programming for the registration brochure, CLE topics, speakers, and speaker contact information and firms**
Monday 1/6/20	**Tax Court Pro Bono Calendar Call-Dallas**

Friday 1/10/20	**Meeting of Council, Committee Chairs, and Committee Vice Chairs** Polsinelli PC 2950 N. Harwood, Suite 2100 Dallas, Texas 75201
Saturday 1/11/20	**Pro Bono Day-Houston and San Antonio**
Friday 1/17/20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Monday 1/20/20	**Martin Luther King Jr. Day (Holiday)**
Thurs - Fri 1/23-24/20	**Leadership Academy San Antonio Session (with Graduation Ceremony)** Chamberlain Hrdlicka 112 E Pecan St Ste 1450 San Antonio TX 78205 (210) 253-8383
Friday 1/24/20	**Submission Deadline – Texas Tax Lawyer (Winter Edition)** Submit to TTL Editor: Michelle Spiegel michelle.spiegel@nortonrosefulbright.com
Monday 1/27/20	**Tax Court Pro Bono Calendar Call-Houston**
Thurs - Sat 1/30-2/1/20	**American Bar Association Section of Taxation Midyear Meeting** Boca Raton, FL
Feb. 2020	
Saturday 2/1/20	**Register and make guest room reservations for Annual Meeting (www.texasbar.com/annualmeeting)**
Monday 2/3/20	**Tax Court Pro Bono Calendar Call- Dallas & San Antonio**
Wednesday 2/5/20	**Officers' Call** 2:00 p.m.
Friday 2/7/20	**SBOT Tax Section Tax Law in a Day CLE** Houston, Texas
Monday 2/17/20	**George Washington's Birthday (Holiday)**
Wednesday 2/19/20	**Law School Outreach – Texas Southern University**

Friday 2/21/20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Monday 2/24/20	**Tax Court Pro Bono Calendar Call – Houston**
Wednesday 2/26/20	**Law School Outreach – St. Mary's University**
Thurs - Fri 2/27-28/20	**International Fiscal Association Annual Congress** Boston MA
Friday 2/28/20	**Council of Chairs Meeting and Section Representative Election** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
March 2020	
Sunday 3/1/20	**Nomination Deadline for Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members**
Monday 3/2/20	**Annual Meeting Deadline: Order special awards, council and chair plaques, food and beverage and audio visuals**
Tuesday 3/3/20	**Law School Outreach – University of Texas School of Law**
Wednesday 3/4/20	**Officers' Call** 2:00 p.m.
Friday 3/20/20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Tuesday 3/24/20	**Nominating Committee Report Due to Council** (Bylaws 4.1)
Friday 3/27/20	**2020s State Bar of Texas Property Tax Committee Meeting & Legal Seminar** Thompson Conference Center - UT Campus 2405 Robert Dedman Dr. Austin, Texas 78712
Sun - Wed 3/29-4/1/20	**Annual Meeting of Unclaimed Property Professionals Organization (UPPO)** JW Marriott Starr Pass Tucson, AZ

Monday 3/30/20	**Tax Court Pro Bono Calendar Call-Dallas**
April 2020	
Wednesday 4/1/20	**Nominations for Outstanding Texas Tax Lawyer Due to Dan Baucum** Email**:** (dbaucum@baucumlaw.com)
Wednesday 4/1/20	**Officers' Call** 2:00 p.m.
Friday 4/3/20	**Meeting of Council** Polsinelli PC 2950 N. Harwood, Suite 2100 Dallas, Texas 75201 **Note: Council Vote and Selection of Recipient of 2020 Outstanding Texas Tax Lawyer Award**
Monday 4/6/20	**Law Student Scholarship Application Deadline**
Wed-Thurs 4/8-16/20	**Passover (Religious Holiday)**
Friday 4/10/20	**Submission Deadline – Texas Tax Lawyer (Spring Edition)** Submit to TTL Editors: Michelle Spiegel michelle.spiegel88@gmail.com and Aaron Borden Aaron.Borden@us.gt.com.
Fri – Sun 4/10-12/20	**Good Friday, Easter (Religious Holiday)**
Friday 4/17/20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Monday 4/15/20	**Annual Meeting Deadline: course materials for app; CLE articles, PowerPoints, speaker bios and photos**
Monday 4/20/20	**Tax Court Pro Bono Calendar Call – Houston**
Monday 4/22/20	**Annual Meeting Deadline: submit any final programming changes for onsite event guide; CLE topic titles, speakers, speaker contact information and firm**
Thurs - Sat 4/29-5/2/20	**American Bar Association Section of Taxation May Meeting** Marriott Marquis, Washington, DC

May 2020	
Wednesday 5/6/20	**Officers' Call** 2:00 p.m.
Monday 5/11/20	**Last Day of Early Bird Registration for Annual Meeting**
Monday 5/11/20	**Tax Court Pro Bono Calendar Call – Dallas**
Friday 5/15/20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Monday 5/18/20	**Deadline to make guest room reservations for Annual Meeting at discounted rate (www.texasbar.com/annualmeeting)**
Monday 5/25/20	**Memorial Day Holiday**
June 2020	
Wednesday 6/3/20	**Officers' Call** 2:00 p.m.
Wed – Fri 6/3-5/20	**Annual Texas Federal Tax Institute** La Cantera Resort, San Antonio, Texas
Tuesday 6/5/20	**Deadline to Deliver to Members or Post on Tax Section Website Notice of Annual Meeting** (Bylaws 7.1) **Nominating Committee Report to be Posted on Tax Section Website** (Bylaws 4.1)
Monday 6/8/20	**Tax Court Pro Bono Calendar Call – Houston**
Monday 6/15/20	**Tax Court Pro Bono Calendar Call – Dallas**
Friday 6/19/20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Thurs – Fri 6/25-26/20	**SBOT Annual Meeting** Hilton Anatole, Dallas, Texas
TBD	**Tax Section Council Planning Retreat**

TBD	**Presentation of Outstanding Texas Tax Lawyer**
Thursday 6/25/20	**2020 Tax Section Annual Meeting Speaker's Dinner**
Friday 6/26/20	**2020 Tax Section Annual Meeting Program**
Friday 6/26/20	**Award Presentation to Council and Chairs During Tax Section Annual Meeting Program**
August 2020	
Thurs – Fri 8/27-28/20	**Tax Law 2020: A Practical Guide to Tax Law in the Real World** Citiplace Conference Center Dallas TX
Other Events Not Yet Scheduled	
TBD	**SBOT Tax Section Deep Dive Tax Workshop CLE**
TBD	**Additional Law School Outreach Programs**
Future Annual Meeting Dates and Locations	
Thurs-Fri 6/17-18/21	**State Bar of Texas Annual Meeting** Omni Hotel and Fort Worth Convention Center, Fort Worth,
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 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

2019-2020

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TAX SECTION
THE STATE BAR OF TEXAS
COMMITTEE CHAIRS AND VICE CHAIRS
2019-2020

	COMMITTEE	CHAIR	VICE CHAIR
1.	**Annual Meeting**	**Dallas** **Tax Section Officers**	**Fort Worth** **Houston** **Austin** **Abbey B. Garber** Thompson & Knight 1722 Routh Street, Suite 1500 Dallas, Texas 75201 *(214) 969-1640* Abbey.Garber@tklaw.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**	**Michael Threet** Haynes and Boone, LLP 2323 Victory Avenue, Suite 700 Dallas, Texas 75219 *(214) 651-5091* michael.threet@haynesboone.com **Amanda Traphagan** Seay & Traphagan, PLLC 807 Brazos St., Suite 304 Austin, Texas 78701 *(512) 582-0120* atraphagan@seaytaxlaw.com	
3.	**Corporate Tax**	**Kelly Rubin** Jones Day 2727 North Harwood Street Dallas, Texas 75201-1515 *(214) 969-3768* krubin@jonesday.com	**Jim Dossey** Dossey & Jones 25025 I-45 #575 The Woodlands, TX 77380 *(281) 410-2792* jim@dossey.com

4.	**Employee Benefits**	**James R. Griffin** Scheef & Stone LLP 500 N. Akard, Suite 2700 Dallas, Texas 75201 *(214) 706-4209* jim.griffin@solidcounsel.com	**Jessica S. Morrison** Thompson & Knight LLP 777 Main Street, Suite 3300 Fort Worth, TX 76102 *(817) 347-1704* Jessica.Morrison@tklaw.com **Misty Leon** Wilkins Finston Law Group LLP Galleria Tower III 13155 Noel Road, Suite 900 Dallas, TX 75240 *(972) 359-0087* MLeon@wifilawgroup.com
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6.	**Estate and Gift Tax**	**Celeste C. Lawton** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 *(713) 651-5278* celeste.lawton@nortonrosefulbright.com **Laurel Stephenson** Davis Stephenson, PLLC 100 Crescent Ct., Suite 440 Dallas, Texas 75201 *(214) 396-8800* laurel@davisstephenson.com **Carol Warley** RSM US LLP 1330 Post Oak Blvd., Suite 2400 Houston, Texas 77056 *(713) 625-3583* carol.warley@rsmus.com	**Andrew Wagnon** RSM US LLP 1330 Post Oak Blvd., Suite 2400 Houston, Texas 77056 *(713) 625-3500 or (713) 335-8641* Andrew.Wagnon@rsmus.com **Matthew S. Beard** Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP 901 Main St., Suite 3700 Dallas, Texas 75202 *(214) 749-2450* mbeard@meadowscollier.com

7.	**General Tax Issues**	**Prof. Bruce McGovern** South Texas College of Law 1303 San Jacinto Houston, Texas 77002 *(713) 646-2920* bmcgovern@stcl.edu **Prof. Bret Wells** George Butler Research Professor and Associate Professor of Law University of Houston Law School 4604 Calhoun Road Houston, TX 77204-6060 *713-743-2502* bwells@central.uh.edu	**Dustin Whittenburg** Law Office of Dustin Whittenburg 4040 Broadway, Suite 450 San Antonio, Texas 78209 *(210) 826-1900* dustin@whittenburgtax.com
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14.	**Tax-Exempt Finance**	**Peter D. Smith** Norton Rose Fulbright 98 San Jacinto Blvd., Suite 1100 Austin, Texas 78701 *(512) 536-3090* peter.smith@nortonrosefulbright.com **Adam Harden** 300 Convent St, Suite 2100 San Antonio, Texas 78205 *(210) 270-7120* adam.harden@nortonrosefulbright.com	
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20.	**Leadership Academy**	**Robert C. Morris** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 *(713) 651-8404* robert.morris@nortonrosefulbright.com	TBD
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