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).

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[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 potentially 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.