RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

C. Reasonable Compensation

D. Miscellaneous Deductions

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

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

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

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

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

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F. Partnership Audit Rules

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

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

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

G. Miscellaneous

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

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

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

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

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

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

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

B. Identified "tax avoidance transactions"

C. Disclosure and Settlement

D. Tax Shelter Penalties

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

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

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

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

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

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

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

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

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

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

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

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

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

B. Charitable Giving

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

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

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

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

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

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

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

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

B. Discovery: Summonses and FOIA

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

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

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

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

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

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

F. Liens and Collections

G. Innocent Spouse

H. Miscellaneous

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

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

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

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

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

B. Self-employment Taxes

C. Excise Taxes

XII. TAX LEGISLATION

XIII. TRUSTS, ESTATES & GIFTS