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

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

> Although WRP I deducted its property taxes, those taxes directly benefit the growing of the almond trees and are allocable to the produced property (the almond trees) that will produce income in the future. Allowing a current deduction of the property taxes would distort WRP I's actual income for the subject years and would otherwise allow

> WRP I to offset its unrelated income. This is precisely the mismatch of expenses and revenues that section 263A was enacted to prevent.

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

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

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

C. <u>Reasonable Compensation</u>

D. <u>Miscellaneous Deductions</u>

1. Standard mileage rates for 2019. Notice 2019-2, 2019-2 I.R.B. 281 (12/14/18). The standard mileage rate for business miles in 2019 goes up to 58 cents per mile (from 54.5 cents in 2018) and the medical/moving rate goes up to 20 cents per mile (from 18 cents in 2018). The charitable mileage rate remains fixed by § 170(i) at 14 cents. The portion of the business standard mileage rate treated as depreciation goes up to 26 cents per mile for 2019 (from 25 cents in 2018). The maximum standard automobile cost may not exceed $50,400 (up from $50,000 in 2018) for passenger automobiles (including trucks and vans) for trucks and vans for purposes of computing the allowance under a fixed and variable rate (FAVR) plan.

- The notice reminds taxpayers that (1) the business standard mileage rate cannot be used to claim an itemized deduction for unreimbursed employee travel expenses because, in the 2017 Tax Cuts and Jobs Act, Congress disallowed miscellaneous itemized deductions for 2019, and (2) the standard mileage rate for moving has limited applicability for the use of an automobile as part of a move during 2019 because, in the 2017 Tax Cuts and Jobs Act, Congress disallowed the deduction of moving expenses for 2019 (except for members of the military on active duty who move pursuant to military orders incident to a permanent change of station, who can still use the standard mileage rate for moving).

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

1. **General Rule.** No deduction shall be allowed under this chapter for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee.
2. **Exception.** In the case of any qualified bicycle commuting reimbursement (as described in section 132(f)(5)(F)), this subsection shall not apply for any amounts paid or incurred after December 31, 2017, and before January 1, 2026.

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

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

a. Guidance on determining the nondeductible portion of the cost of employer-provided parking. Notice 2018-99, 2018-52 I.R.B. 1067 (12/10/18). In this notice, the IRS announced that Treasury and the IRS will issue proposed regulations under § 274 that will include guidance on determining nondeductible parking expenses and other expenses for qualified transportation fringes (and also the calculation of increased unrelated business taxable income (UBTI) of tax-exempt organizations that provide qualified transportation fringes). Until further guidance is issued, employers that own or lease parking facilities where their employees park can rely on interim guidance provided in the notice to determine the nondeductible portion of parking expenses under § 274(a)(4) and the corresponding increase in the amount of UBTI under § 512(a)(7) attributable to nondeductible parking expenses.

Employer Pays a Third Party for Employee Parking Spots. According to the notice, in situations in which an employer pays a third party an amount so that employees may park at the third party's parking lot or garage, the amount disallowed by § 274(a)(4) generally is the taxpayer's total annual cost of employee parking paid to the third party. Nevertheless, if the amount paid by the employer exceeds the § 132(f)(2) monthly limitation on exclusion ($260 for 2018 and $265 for 2019), the employer must treat the excess amount as compensation and wages to the employee. Accordingly, the excess amount is not disallowed as a deduction pursuant to § 274(e)(2), which provides that § 274(a) does not disallow as a deduction expenses for goods, services, and facilities to the extent the taxpayer treats the expenses as wages to its employees. The result is that the employer can deduct the monthly cost of parking provided to an employee to the extent the cost exceeds the § 132(f)(2) monthly limitation. These rules are illustrated by examples 1 and 2 in the notice.

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

E. Depreciation & Amortization

F. Credits

G. Natural Resources Deductions & Credits

H. Loss Transactions, Bad Debts, and NOLs

I. At-Risk and Passive Activity Losses

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. The IRS searched unsuccessfully for sale or exchange treatment on Monster.com. Estate of McKelvey v. Commissioner, 148 T.C. 312 (4/19/17). The decedent in this case was the founder and CEO of Monster Worldwide, Inc. (Monster), known for its job-search website, monster.com. In 2008, the decedent entered into variable prepaid forward contracts (VPFC) with two investment banks. Pursuant to the terms of each VPFC, the decedent received a cash payment from each investment bank in exchange for his agreement to deliver Monster shares or their cash equivalents over the course of several future settlement dates. The number of shares of Monster that the decedent was obligated to deliver varied and was determined by a formula that took into account the closing price of Monster shares on the settlement dates. In connection with each VPFC, the decedent pledged a specified number of shares of Monster stock to secure his obligations but could substitute other collateral with the bank's consent. In the same year, prior to the first settlement date, the decedent entered into an agreement with each investment bank pursuant to which the decedent made a cash payment to each bank in exchange for the bank's agreement to extend the settlement dates. Following the decedent's death, his estate delivered the requisite number of Monster shares to the banks. The IRS acknowledged that the initial VPFCs qualified for open transaction reporting under Rev. Rul. 2003-7, 2003-1 C.B. 363. However, the IRS took the position that the agreements pursuant to which the settlement dates were extended: (1) were taxable exchanges of the original VPFCs for the extended VPFCs that resulted in short-term capital gain of $88 million, and (2) resulted in constructive sales of the underlying Monster shares under § 1259 that gave rise to long-term capital gain of $112.8 million. The Tax Court (Judge Ruwe) held that the extension agreements did not result in taxable exchanges and that the extensions did not constitute constructive sales under § 1259. The court reasoned that, in order for the extensions to constitute taxable exchanges of the VPFCs, "two conditions must be satisfied: (1) the original VPFCs must constitute property to decedent at the time of the extensions and (2) the property must be exchanged for other property differing materially either in kind or in extent." The first condition, the court concluded, was not satisfied. The VPFCs were not property of the decedent, but rather obligations of the decedent. Once the decedent had received the cash payments under the VPFCs, the decedent had only the obligation to deliver a specified number of Monster shares or their cash equivalent. The court also rejected the government's argument that the extensions resulted in constructive sales of the underlying Monster shares under § 1259. Section 1259(a)(1) provides that, if there is a constructive sale of an appreciated financial position, the taxpayer must recognize gain as if that position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale. Under § 1259(c)(1)(C), a constructive sale of an appreciated financial position occurs if a taxpayer "enters into a future or forward contract to deliver the same or substantially identical property," but according to the provision's legislative history, a forward contract does not result in a constructive sale of stock if it calls for the delivery of "an amount of property, such as shares of stock, that is subject to significant variation under the contract terms." The court reasoned that the IRS's acceptance of open transaction reporting for the initial VPFCs meant that the IRS acknowledged that the initial VPFCs did not trigger a constructive sale under § 1259. Accordingly, the IRS's argument that the extensions resulted in constructive sales under § 1259 "is predicated upon a finding that there was an exchange of the extended VPFCs for the original VPFCs," a finding that the court had already declined to make.

a. But the Second Circuit has determined that the IRS's search for taxes is not yet finished. Estate of McKelvey v. Commissioner, 906 F.3d 26 (2d Cir. 9/26/18), *rev'g and remanding* 148 T.C. No. 13. The Second Circuit, in an opinion by Judge Newman, reversed the Tax Court's decision against the IRS and in favor of the decedent-taxpayer and remanded the case for a determination of both the potential short-term capital gain and long-term capital gain to be recognized in 2008 prior to the decedent-taxpayer's death. Although the Second Circuit agreed with the Tax Court that the extension of the VPFCs in 2008 did not equate to a taxable exchange of the VPFCs because the contracts were obligations, not property, the Second Circuit sided with the IRS that the extensions could be "terminations" of the VPFCs resulting in gain under § 1234A. Section 1234A provides that "[g]ain . . . attributable to the cancellation . . . or other termination of . . . a right or obligation . . . with respect to property which is . . . a capital asset in the hands of the taxpayer . . . shall be treated as gain . . . from the sale of a capital asset." The IRS had not argued the application of § 1234A in the Tax Court; however, for reasons that are not clear from the opinion both the decedent-taxpayer and the IRS agreed that the issue could be raised on appeal. The Second Circuit reasoned that although the 2008 extension of the original VPFCs was not a sale or exchange giving rise to gain, the 2008 extension did rise to the level of a *new contract*, not merely a "continuation" of the original VPFCs as the Tax Court had held. Therefore, the Second Circuit decided that with respect to the issue of recognition of short-term capital gain in 2008 and the amount thereof (if any), the case should be remanded to Tax Court to determine if the extension amounted to a "termination" of the original VPFCs within the meaning of § 1234A. With respect to the issue of long-term capital gain recognizable by the decedent-taxpayer in 2008, the IRS made the same argument that it had made in the Tax Court. Namely, that a constructive sale occurred with respect to the decedent-taxpayer's Monster.com shares in 2008 under § 1259 when the VPFCs were extended. Section 1259 provides for constructive sale treatment if a taxpayer holds an "appreciated financial position" in stock and enters into a "forward contract to deliver the same or substantially identical property." § 1259(c)(1)(C). A "forward contract" is defined for this purpose as "a contract to deliver *a substantially fixed amount of property* (including cash) at a substantially fixed price." § 1259(d)(1) (emphasis added). Neither the IRS nor the estate disputed that on the date the original VPFCs were extended the decedent-taxpayer's Monster.com stock was in an "appreciated financial position." The dispute centered upon whether the decedent-taxpayer's Monster.com shares were a "substantially fixed amount of property." Under the original VPFCs, the Monster.com shares to be delivered under the VPFCs were not substantially fixed because fluctuations in the value would affect the shares ultimately delivered to the banks. Nonetheless, the IRS argued that in 2008 when the original VPFCs were extended, new contracts were created under § 1259 and the amount of Monster.com shares to be delivered to the banks under the new VPFCs became "substantially fixed" before the decedent-taxpayer's death. The amount of Monster.com shares to be delivered became substantially fixed, according to the IRS, because of a dramatic drop in the market value of the Monster.com shares. Specifically, and based upon expert testimony, the IRS asserted that there was a probability of over 85 percent that all the Monster.com shares pledged under the VPFCs would be required to be delivered upon eventual settlement scheduled for 2010. The Second Circuit first agreed with the IRS that the extended VPFCs were new contracts for purpose of IRC § 1259, not merely "continuations" as the Tax Court had held. Next, acknowledging that no court had addressed whether probability analysis can be used to determine if an amount of property is "substantially fixed" for purposes of finding a constructive sale under § 1259, the Second Circuit decided (citing a deep-in-the-money option case, *Progressive Corp. v. United States*, 970 F.2d 188 (6th Cir. 1992), as precedent) that using probability analysis was appropriate in this case. On this basis, the Second Circuit decided that the 85 percent plus probability of all Monster.com shares being used to settle the amended VPFCs as found by the IRS's expert was sufficient to substantially fix the amount of property within the meaning of § 1259. Accordingly, the Second Circuit agreed with the IRS that under § 1259 a constructive sale of the decedent-taxpayer's Monster.com took place in 2008 before the decedent-taxpayer's death; however, the Second Circuit remanded the case to the Tax Court to determine the amount of long-term capital gain that the decedent-taxpayer should recognize in 2008. Judge Cabranes wrote a concurring opinion to clarify that the Second Circuit's analysis does not affect the application of Reg. § 1.1001-3 to holders and issuers of *debt* instruments.

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

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

1. The economic benefits resulting from an S corporation's payment of premiums on a shareholder-employee's life insurance policy under a compensatory split-dollar arrangement are treated as distributions to the shareholder, not as compensation. Machacek v. Commissioner, 906 F.3d 429 (6th Cir. 10/12/18), *rev'g* T.C. Memo. 2016-55 (3/28/16). The taxpayer and his wife were the sole shareholders of a subchapter S corporation. The taxpayer also was an employee of the S corporation. Pursuant to a benefit plan adopted by the S corporation, the corporation paid the $100,000 annual premium on a life insurance policy on the taxpayer's life under an arrangement that the parties agreed was a compensatory split-dollar arrangement. The Tax Court (Judge Laro) had held that the taxpayers had to include in income the economic benefit of the arrangement. In an opinion by Judge White, the Sixth Circuit reversed and remanded and held that the economic benefits of the arrangement must instead be treated as distributions of property by the S corporation. The court relied on Reg. § 1.301-1(q)(1)(i), which provides:

> the provision by a corporation to its shareholder pursuant to a split-dollar life insurance arrangement, as defined in § 1.61-22(b)(1) or (2), of economic benefits described in § 1.61-22(d) . . . is treated as a distribution of property.

This provision, the court stated, applies whether the split-dollar arrangement is a shareholder arrangement or a compensatory arrangement and is dispositive. Thus, according to the court, when a shareholder-employee receives benefits under a compensatory arrangement, the "benefits are treated as a distribution of property and are thus deemed to have been paid to the shareholder in his capacity as a shareholder."

D. Individual Retirement Accounts

V. PERSONAL INCOME AND DEDUCTIONS

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

C. Liquidations

D. S Corporations

E. Mergers, Acquisitions and Reorganizations

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

1. After reading a combined 140+ pages, how about next time we just flip a coin? Surely the answer cannot be as simple as the outcome: Owning related-party DISC stock via a Roth IRA is OK, but owning related-party FSC stock via a Roth IRA is not OK? The following recent cases dramatically illustrate the uncertainties faced by advisors, the IRS, and the courts when deciding between transactions that constitute creative but legitimate tax planning and those that are considered "abusive." Both cases centered on taxpayers using statutorily-sanctioned tax-planning devices in tandem (Roth IRAs coupled with a DISC or a FSC). Nonetheless, a Sixth Circuit panel unanimously held for the taxpayer while a majority of the Tax Court held for the IRS (even after considering the Sixth Circuit's decision). Moreover, the Sixth Circuit and the Tax Court reached conflicting conclusions notwithstanding the fact that the taxpayers and the IRS agreed there was *no significant difference* between the cases in either the relevant facts or the controlling law. If this is no surprise to you, you can stop here. If you are intrigued, read further.

a. Form is substance, says the Sixth Circuit. The IRS is precluded from recharacterizing a corporation's payments to a DISC held by a Roth IRA. Summa Holdings, Inc. v. Commissioner, 848 F.3d 779 (6th Cir. 2/16/17), *rev'g* T.C. Memo 2015-119 (6/29/15). Two members of the Benenson family each established a Roth IRA by contributing $3,500. Each Roth IRA paid $1,500 for shares of a Domestic International Sales Corporation (DISC). These members of the Benenson family were the beneficial owners of 76.05 percent of the shares of Summa Holdings, Inc., the taxpayer in this case and a subchapter C corporation. Summa Holdings paid (and deducted) commissions to the DISC, which paid no tax on the commissions. The DISC distributed dividends to each of the Roth IRAs, which paid unrelated business income tax on the dividends (at roughly a 33 percent rate according to the court) pursuant to § 995(g). (The structure involved a holding company between the Roth IRA and the DISC, but the presence of the holding company appears not to have affected the tax consequences.) This arrangement allowed the balance of each Roth IRA to grow rapidly. From 2002 to 2008, the Benensons transferred approximately $5.2 million from Summa Holdings to the Roth IRAs through this arrangement, including $1.5 million in 2008, the year in issue. By 2008, each Roth IRA had accumulated over $3 million. The IRS took the position that the arrangement was an impermissible way to avoid the contribution limits that apply to Roth IRAs. The IRS disallowed the deductions of Summa Holdings for the commissions paid to the DISC and asserted that, under the substance-over-form doctrine, the arrangement should be recharacterized as the payment of dividends by Summa Holdings to its shareholders, followed by contributions to the Roth IRAs by the two members of the Benenson family who established them. The IRS determined that each Roth IRA had received a deemed contribution of $1.1. By virtue of their level of income, the two Benenson family members were ineligible to make any Roth IRA contributions. Pursuant to § 4973, the IRS imposed a 6 percent excise tax on the excess contributions.

The Tax Court's decision (Summa I). The Tax Court (Judge Kerrigan) upheld the IRS's recharacterization. Judge Kerrigan relied upon *Repetto v. Commissioner*, T.C. Memo 2012-168 and Notice 2004-8, 2004-1 C.B. 333, both of which addressed using related-party businesses and Roth IRAs in tandem to circumvent excess contribution limits. Foreshadowing its argument in *Repetto*, the IRS had announced in Notice 2004-8 that these arrangements were listed transactions and that it would attack the arrangements on several grounds, including "that the substance of the transaction is that the amount of the value shifted from the Business to the Roth IRA Corporation is a payment to the Taxpayer, followed by a contribution by the Taxpayer to the Roth IRA and a contribution by the Roth

IRA to the Roth IRA Corporation." Importantly, subsequent Tax Court decisions, *Polowniak v. Commissioner*, T.C. Memo 2016-31 and *Block Developers, LLC v. Commissioner*, T.C. Memo 2017-142, adopted the IRS's position in Notice 2004-8 and struck down tandem Roth IRA/related-party business arrangements like the one under scrutiny in *Summa I*.

The Sixth Circuit's decision (Summa (II)). In an opinion by Judge Sutton, the U.S. Court of Appeals for the Sixth Circuit reversed.[1] The court emphasized that "[t]he Internal Revenue Code allowed Summa Holdings and the Benensons to do what they did." The issue was whether the IRS's application of the substance-over-form doctrine was appropriate. The court first expressed a great deal of skepticism about the doctrine:

> Each word of the "substance-over-form doctrine," at least as the Commissioner has used it here, should give pause. If the government can undo transactions that the terms of the Code expressly authorize, it's fair to ask what the point of making these terms accessible to the taxpayer and binding on the tax collector is. "Form" is "substance" when it comes to law. The words of law (its form) determine content (its substance). How odd, then, to permit the tax collector to reverse the sequence—to allow him to determine the substance of a law and to make it govern "over" the written form of the law—and to call it a "doctrine" no less.

Although the court expressed the view that application of the substance-over-form doctrine makes sense when a "taxpayer's formal characterization of a transaction fails to capture economic reality and would distort the meaning of the Code in the process," this was not such a case. The substance-over-form doctrine as applied by the IRS in this case, the court stated, was a "distinct version" under which the IRS claims the power to recharacterize a transaction when there are two possible options for structuring a transaction that lead to the same result and the taxpayer chooses the lower-tax option. The court concluded that the IRS's recharacterization of Summa Holding's transactions as dividends followed by Roth IRA contributions did not capture economic reality any better than the taxpayer's chosen structure of DISC commissions followed by dividends to the DISC's shareholders.

b. Not so fast, says the Tax Court. The IRS can still win a Roth IRA case if a tax-saving corporation's stock is in substance owned by individual shareholders instead of their Roth IRAs. Mazzei v. Commissioner, 150 T.C. No. 7 (03/05/18). The taxpayers in this case were members of the Mazzei family (husband, wife, and adult daughter). They owned 100 percent of the stock of Mazzei Injector Corp., an S corporation. The taxpayers established separate Roth IRAs that each invested $500 in a Foreign Sales Corporation ("FSC"). Under prior law and somewhat like DISCs, FSCs provided a Code-sanctioned tax benefit because they were taxed at much lower rates than regular corporations pursuant to an express statutory regime. After the taxpayers' Roth IRAs invested in the FSC, Mazzei Injector Corp. paid the FSC a little over $500,000 in deductible commissions from 1998 to 2002. These deductible payments exceeded the amounts the taxpayers could have contributed to their Roth IRAs over these years, and just as in *Summa Holdings*, the IRS argued that substance over form principles applied to recharacterize the entire arrangement as distributions by the S corporation to its shareholders, followed by excess Roth IRA contributions subject to the § 4973 excise tax and related penalties. Because the case is appealable to the Ninth Circuit, the Tax Court was not bound by the Sixth Circuit's decision in *Summa Holdings*. Thus, the Tax Court could have followed its own decision in *Summa Holdings* to agree with the IRS that in substance the entire arrangement amounted to an end-run around Roth IRA contribution limits; however, the Tax Court did not adopt this *Summa Holdings*-inspired approach. Instead, in a reviewed opinion (12-0-4) by Judge Thornton, relying upon Ninth Circuit precedent as well as the U.S. Supreme Court's decision in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), the Tax Court reasoned that the Roth IRAs had no real downside risk or exposure with respect to holding the FSC

[1] Although the Tax Court had both disallowed Summa Holdings' deductions for the commissions paid to the DISC and upheld imposition of the 6 percent excise tax of § 4973 on the deemed excess Roth IRA contributions made by Summa Holdings' shareholders, Summa Holdings appealed to the Sixth Circuit only the disallowance of its deductions. The shareholders have appealed to the First and Second Circuits the issue whether they made excess Roth IRA contributions. Those appeals are currently pending.

stock and thus were not the true owners of the stock. Judge Thornton determined that, for federal income tax purposes, the taxpayers should be considered the owners of the stock, stating:

> [B]ecause petitioners (through various passthrough entities) controlled every aspect of the transactions in question, we conclude that they, and not their Roth IRAs, were the owners of the FSC stock for Federal tax purposes at all relevant times. The dividends from the FSC are therefore properly recharacterized as dividends from the FSC to petitioners, followed by petitioners' contributions of these amounts to their respective Roth IRAs. All of these payments exceeded the applicable contribution limits and were therefore excess contributions. We therefore uphold respondent's determination of excise taxes under section 4973.

Notably, though, the Tax Court declined to impose penalties on the taxpayers because they relied on independent professional advice in connection with setting up the FSC and their Roth IRAs.

- *Dissenting opinion.* Four Judges (Holmes, Foley, Buch, and Morrison) dissented, with some joining only parts of the dissenting opinion written by Judge Holmes. Judge Holmes reasoned that the majority should have followed the Sixth Circuit's decision in *Summa Holdings* instead of engaging in "judge-made doctrine." In our view, Judge Holmes's dissenting opinion is both entertaining and insightful, summing up the conflicting opinions in *Summa I*, *Summa II*, and *Mazzei* as follows: "What's really going on here is that the Commissioner doesn't like that the Mazzeis took two types of tax-advantaged entities and made them work together." Judge Holmes also aptly observed:

> After the Sixth Circuit released *Summa II* we told the parties here to submit supplemental briefs. The Mazzeis and the Commissioner agreed that the only difference between these cases and *Summa II* was that the Mazzeis used a FSC instead of a DISC. The Commissioner said this difference shouldn't affect our analysis, and he admitted that the Mazzeis followed all of the necessary formalities. He nevertheless said we should ignore *Summa II* because it's from a different circuit and only the commission payments' deductibility was properly before the court there. He said we should instead follow *Court Holding*, look at the transaction as a whole, and decide the cases based on his views of the statute's intent, not the Code's plain language.
>
> The Mazzeis urged us to follow *Summa II*'s reasoning. They said they should get the FSC and Roth IRA tax benefits the Code explicitly provides and that the Commissioner shouldn't get to rewrite statutes based on his musings about congressional intent. And they said that their use of an FSC instead of a C corporation was enough to distinguish these cases from Repetto.

- *Our conclusion? Flip a coin.* Tax advisors setting up these tandem Roth IRA/related-party business arrangements, at least where the structure involves a corporation that enjoys statutorily-sanctioned tax benefits--*such as a very low 21 percent rate, perhaps?*--may prefer to flip a coin than to predict the ultimate outcome, at least outside the Sixth Circuit. One thing is almost certain, though: We will be reading and writing more about tandem Roth IRA/related-party business arrangements in the near future.

c. The First Circuit has agreed with the Sixth Circuit and declined to recharacterize a corporation's payments to a DISC held by a Roth IRA. Benenson v. Commissioner, 887 F.3d 511 (1st Cir. 4/6/18), *rev'g* T.C. Memo 2015-119 (6/29/15). In an opinion by Judge Stahl, the U.S. Court of Appeals for the First Circuit has upheld the same Roth IRA-DISC transaction considered by the Sixth Circuit in *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779 (6th Cir. 2/16/17). In that transation, members of the Benenson family established Roth IRAs that acquired shares of a Domestic International Sales Corporation (DISC), to which a subchapter C corporation (Summa Holdings) paid (and deducted) commissions to the DISC. The Tax Court upheld the IRS's recharacterization of the transaction under the substance over form doctrine. Under the IRS's view of the transaction, the C corporation's payments of commissions to the DISC should be recharacterized as nondeductible distributions by the C corporation to its shareholders, followed by the shareholders' contributions of those amounts to their Roth IRAs in excess of applicable limits, which triggered the 6 percent excise tax of § 4973 The Sixth Circuit addressed the C corporation's deductions and rejected the IRS's argument that the C corporation's deductions should be disallowed under the substance over form doctrine. In this case, the First Circuit considered the appeal of the Tax Court's decision by shareholders who were residents of Massachusetts, who appealed the Tax Court's decision that they should be treated as having made excess Roth IRA contributions. Like the Sixth Circuit, the First Circuit declined to apply the substance over form doctrine, which the court characterized as "not a smell test," but rather a tool of statutory interpretation. The court reasoned that Congress appeared to contemplate ownership of DISCS by IRAs when it enacted relevant statutory provisions such as § 995(g), which imposes unrelated business income tax on distributions that a DISC makes to tax-exempt organizations that own shares of the DISC. The court concluded:

> The Benensons used DISCs, a unique, congressionally designed corporate form their family's business was authorized to employ, and Roth IRAs, a congressionally designed retirement account all agree they were qualified to establish, to engage in long-term saving with eventual tax-free distribution. Such use violates neither the letter nor the spirit of the relevant statutory provisions.
>
> …
>
> Some may call the Benensons' transaction clever. Others may call it unseemly. The sole question presented to us is whether the Commissioner has the power to call it a violation of the Tax Code. We hold that he does not. … When, as here, we find that the transaction does not violate the plain intent of the relevant statutes, we can push the doctrine no further.

- In a dissenting opinion, Judge Lynch argued that the IRS's application of the substance over form doctrine should be upheld. In Judge Lynch's view, the parties had not used the DISC for the purpose intended by Congress, but rather to evade the Roth IRA contribution limits. Judge Lynch also disagreed with the majority that the relevant statutory provisions contemplated a Roth IRA holding stock in a DISC. At most, Judge Lynch noted, Congress might have intended to allow traditional IRAs to own DISC stock, but taxpayers have not used DISCs as a way to circumvent the contribution limits on traditional IRAs because, in contrast to Roth IRAs, distributions from a traditional IRA are not tax-free.

d. The Second Circuit has jumped on the bandwagon and declined to apply the substance-over-form doctrine to recharacterize a corporation's payments to a DISC held by a Roth IRA. Benenson v. Commissioner, 910 F.3d 690 (2d Cir. 12/14/18). In an opinion by Judge Raggi, the U.S. Court of Appeals for the Second Circuit has agreed with the First and Sixth Circuits that the government could not apply the substance-over-form doctrine to recharacterize as nondeductible dividends the commissions paid by Summa Holdings, Inc. to a DISC, the stock of which was held (indirectly) by Roth IRAs formed by some of Summa Holdings' shareholders. The court first rejected the taxpayers' argument that the Sixth Circuit's decision, which refused to uphold application of the substance-over-form doctrine with respect to Summa Holdings, precluded the government from relitigating the issue of recharacerization. The court observed that offensive collateral estoppel can preclude the government from relitigating an issue only when the parties opposing the government in the prior and subsequent action are the same. This requirement can be satisfied, the court stated, when the litigant in the subsequent action (the shareholders in this case) totally controlled and financed the litigant in the prior action (the corporation, Summa Holdings). According to the court, however, the taxpayers had failed to make this showing, and therefore the government was not precluded from litigating the issue of recharacterization. With respect to the issue of recharacterizing Summa Holdings' payment of commissions to the DISC, the court held that "the substance-over-form doctrine does not support recharacterization of Summa's payment of tax-deductible commissions to a DISC as taxable constructive dividends to Summa shareholders and, thus, cannot support the tax deficiency attributed to petitioners. The court also held that the step-transaction doctrine, when applied together with the substance-over-form doctrine, did not warrant a different conclusion.

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

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

The court first analyzed the nature of the gain realized by the taxpayer. Under § 736(b)(1), payments made in liquidation of the interest of a retiring partner that are made in exchange for the partner's interest in partnership property are treated as a distribution to the partner. Treatment as a distribution triggers § 731(a)(1), which provides that a partner recognizes gain from a distribution to the extent the amount of money received exceeds the partner's basis in the partnership interest and directs that the gain recognized "shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner." Pursuant to § 741, gain recognized from the sale or exchange of a partnership interest is "considered as gain or loss from the sale or exchange of a capital asset" except to the extent provided by § 751. (The IRS did not contend that § 751 applied.) The taxpayer asserted that these provisions lead to the conclusion that the taxpayer's gain must be treated as arising from the sale of a single asset, its partnership interest, which is a capital asset. The government argued that the taxpayer's gain must be treated as arising from the sale of separate interests in each asset owned by the partnership. Otherwise, the government argued, the rule in § 897(g), which imposes U.S. tax to the extent amounts received from the sale of a partnership interest are attributable to U.S. real property interests, would be rendered inoperable. The court agreed with the taxpayer. Section 897(g), the court explained,

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

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

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

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

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

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

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

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

b. Proposed regulations implementing new § 864(c)(8) issued. REG-113604-18, Gain or Loss of Foreign Persons From Sale or Exchange of Certain Partnership Interests, 83 F.R. 66647 (12/27/18). Treasury and the IRS have issued proposed regulations that implement new § 864(c)(8). As required by § 864(c)(8), the proposed regulations adopt a two part analysis for determining effectively connected income or loss upon a foreign partner's sale or exchange of its partnership interest. First, § 864(c)(8)(A) requires a foreign partner to apply the normal rules of subchapter K to determine its overall gain or loss (including ordinary income or loss from "hot assets" under § 751) on the transfer of a partnership interest (''outside gain'' and ''outside loss''). Second, the outside gain or outside loss is compared to amounts determined under § 864(c)(8)(B), which can limit otherwise reportable effectively connected income or loss of the foreign partner. Consistent with the IRS's position in *Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner*, 149 T.C. No. 3 (7/13/17), and Rev. Rul. 91-32, 1991-1 C.B. 107, § 864(c)(8)(B) uses a hypothetical partnership level sale or exchange analysis to derive inside ''aggregate deemed sale EC capital gain,'' ''aggregate deemed sale EC capital loss,'' ''aggregate deemed sale EC ordinary gain,'' and ''aggregate deemed sale EC ordinary loss.'' Outside gain or loss determined under § 864(c)(8)(A) then is compared to inside gain or loss determined under § 864(c)(8)(B) to derive the amount ultimately reportable by the foreign partner as effectively connected income or loss upon the sale or exchange of its partnership interest. Thus, for example, a foreign partner would compare its outside capital gain to its aggregate deemed sale EC capital gain, treating the former as effectively connected gain only to the extent it does not exceed the latter. The proposed regulations provide several examples illustrating the application of new § 864(c)(8). The proposed regulations do not, however, address the corresponding modifications to the withholding rules in § 1446(f), stating only that the latter regulations are to be issued "expeditiously."

E. Inside Basis Adjustments

F. Partnership Audit Rules

G. Miscellaneous

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

1. The taxpayer came to regret his decision to organize his business as a C corporation, and a midco transaction failed to solve the problem. Tricarichi v. Commissioner, T.C. Memo 2015-201 (10/14/15). The taxpayer was the sole shareholder of a C corporation, West Side Cellular, Inc. After lengthy litigation regarding network access, West Side received a settlement of $65 million and was required both to terminate its business as a retail provider of cell phone service and to end all service to its customers. To reduce the impact of corporate-level tax, the taxpayer engaged in a midco transaction in which a Cayman Islands affiliate of Fortrend International LLC purchased the stock of West Side for approximately $11.2 million more than the corporation's net asset value (the value of its assets less its estimated federal tax liabilities) and then used a distressed debt strategy to generate a bad debt deduction of $42.4 million to eliminate West Side's tax liabilities. In the notice of deficiency issued to West Side, the IRS determined a deficiency of $15.2 million based on its disallowance of the corporation's bad debt deduction and asserted an accuracy-related penalty of roughly $62,000 and a gross valuation misstatement penalty of $5.9 million. The Tax Court (Judge Lauber) held the taxpayer liable as a transferee for West Side's federal tax liability, the accuracy-related penalty, and the gross valuation misstatement penalty. In order for a shareholder to have transferee liability for a corporation's tax liability, the court stated, two requirements must be satisfied: (1) the shareholder must be liable for the corporation's debts under some provision of state law, and (2) the shareholder must be a "transferee" within the meaning of § 6901. With respect to the first requirement, the court held that the taxpayer was liable as a transferee under Ohio law (the Uniform Fraudulent Transfer Act) for the corporation's tax deficiency as well as the penalties:

> In sum, we find that petitioner had constructive knowledge of Fortrend's tax-avoidance scheme; that the multiple steps of the Midco transaction must be collapsed; and that collapsing these steps yields a partial or complete liquidation of West Side from which petitioner received in exchange for his stock a $35.2 million liquidating distribution. Under [Ohio law], petitioner is thus a direct transferee of West Side's assets under respondent's "de facto liquidation" theory as well as under the "sham loan" theory discussed previously.

With respect to the second requirement, the court disregarded the form of the transaction and concluded that the taxpayer was a transferee within the meaning of § 6901 because the taxpayer had in substance directly received West Side's cash. Any appeal of the court's decision will be directed to the Ninth Circuit.

a. How about a little salt in that wound? The taxpayer also is liable for pre-notice interest of $13.9 million. Tricarichi v. Commissioner, T.C. Memo. 2016-132 (7/18/16). In a supplemental opinion, the Tax Court (Judge Lauber) upheld the government's calculation of pre-notice interest, i.e., interest that accrued on the corporation's unpaid federal income tax liability from the date on which payment was due from the corporation in March 2004 to the date on which the IRS issued the notice of liability to the taxpayer in June 2012. The government asserted that the taxpayer's liability for pre-notice interest must be determined under federal law and computed in accordance with the rules for interest on underpayments in § 6601. According to the government, the pre-notice interest amounted to $13.9 million. The taxpayer contended that his liability for pre-notice interest must be determined under state law, and that under state law his liability for pre-notice interest was zero. The court reviewed prior decisions addressing liability for pre-notice interest, including *Lowy v. Commissioner*, 35 T.C. 393 (1960) and *Estate of Stein*, 37 T.C. 945 (1962), and concluded that courts have applied state law to determine liability for pre-notice interest only when the transferee has received an amount less than the transferor's liability:

> In short, the courts have consulted State law to ascertain whether the Government may recover from the transferee, in the form of pre-judgment interest, an amount larger than the value of the assets the transferee received. Petitioner has cited, and our own research has discovered, no case in which a court has invoked State law governing pre-judgment interest as a basis for reducing the Government's recovery to an amount smaller than the value of the assets the transferee received. That is what petitioner seeks to do here, and there is simply no precedent for it.

Because the taxpayer received from the corporation assets in the amount of $35.2 million, more than the $35.1 million total of the transferor corporation's liability for income tax, penalties, and pre-notice interest, the taxpayer's liability for pre-notice interest was properly determined under federal law. Accordingly, the court held the taxpayer liable as a transferee for $13.9 million in pre-notice interest.

b. The Ninth Circuit has affirmed the Tax Court's holding that the taxpayer was liable as a transferee. Tricarichi v. Commissioner, ___ Fed. Appx. ___ (9th Cir. 11/13/18), *aff'g* T.C. Memo. 2016-132 (7/18/16). In a brief, memorandum opinion, the U.S. Court of Appeals for the Ninth Circuit affirmed the Tax Court's decision that the taxpayer, who sold in a midco transaction the stock of West Side Cellular, Inc., a C corporation of which he was the sole shareholder, was liable as a transferee for the corporation's federal tax liability. The court cited its prior opinion in *Slone v. Commissioner*, 810 599 (9th Cir. 2015), for the two -prong test that must be satisfied for a shareholder to have transferee liability for a corporation's tax liability: (1) the shareholder must be liable for the corporation's debts under some provision of state law, and (2) the shareholder must be a "transferee" within the meaning of § 6901. The court held that the Tax Court had properly concluded that the corporation's cash had been "transferred" to the taxpayer within the meaning of the Ohio Uniform Fruadulent Transfer Act (thus satisfying the first prong), and that the Tax Court had "properly determined, looking through the form of the stock sale to consider its substance, that it lacked a non-tax business purpose or any economic substance other than the creation of tax benefits," which satisfied the second prong of the test.

c. **The Ninth Circuit has affirmed the Tax Court's decision regarding the taxpayer's liability for pre-notice interest.** Tricarichi v. Commissioner, 908 F.3d 588 (11/13/18). In an opinion by Judge Owens, the U.S. Court of Appeals for the Ninth Circuit has affirmed the Tax Court's decision that the taxpayer, who sold in a midco transaction the stock of West Side Cellular, Inc., a C corporation of which he was the sole shareholder, was liable as a transferee not only for the corporation's federal tax liability, but also for pre-notice interest. Pre-notice interest is interest that accrued on the corporation's unpaid federal income tax liability from the date on which payment was due from the corporation in March 2004 to the date on which the IRS issued the notice of liability to the taxpayer in June 2012. In its prior decision in *Edelson v. Commissioner*, 829 F.2d 828, 834 (9th Cir. 1987), the court had held that "[w]here transferee liability is found to exist but the transferred assets are insufficient to satisfy the transferor's total tax liability, a transferee's liability for interest is controlled by state law." The Ninth Circuit had not previously addressed the situation in which the transferee had received assets worth *more* thatn the transferor's total tax liability. The court took note of the Tax Court's prior decisions in *Lowy v. Commissioner*, 35 T.C. 393 (1960) and *Estate of Stein*, 37 T.C. 945 (1962), in which the Tax Court had held that, when the assets transferred are more than the federal tax liability of the transferor (including interest), it is unnecessary to look to state law to determine whether the transferee is liable for pre-notice interest. The court also discussed the First Circuit's opinion in *Schussel v. Werfel*, 758 F.3d 82 (1st Cir. 2014), in which the First Circuit followed *Lowy* and *Estate of Stein*. The Ninth Circuit agreed with the First Circuit's reasoning and held

> that because the value of assets transferred from West Side to Tricarichi is more than West Side's total federal tax liability, the federal Internal Revenue Code determines Tricarichi's pre-notice interest liability, and there is no need to consult state law regarding such interest.

Accordingly, in addition to being liable for the corporate transferor's federal tax liability, the taxpayer was liable for more than $13 million of pre-notice interest.

B. Identified "tax avoidance transactions"

C. Disclosure and Settlement

D. Tax Shelter Penalties

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. **Congress shoots a probable NCAA "airball": After TCJA, it will cost 21 percent more to pay big-time, private school coaches like Coach K (Duke-$7.2M); but Wildcat fans celebrate as Coach Calipari (Kentucky-$6.5M) gets an "assist" from Congress.** Presumably believing that $1 million salaries at tax-exempt organizations are per se unreasonable, Congress decided to take a "shot" (*pun intended*) at curtailing them under TCJA. Specifically, the 2017 Tax Cuts and Jobs Act, § 13602, adds Code § 4960 to impose a 21 percent excise tax on "applicable tax-exempt organizations" ("ATEOs") and broadly-defined "related organizations" paying over $1 million annually to "covered employees." In addition to § 527 political organizations and § 521 farmers cooperatives, ATEOs include the following two additional types of organizations: (i) those exempt from tax under § 501(a) (most nonprofits, including churches, hospitals, and private schools); and (ii) those "with income excluded from taxation under § 115(l)" (income of certain public utilities and income derived from "any essential governmental function and accruing to a State or any political subdivision thereof"). A "covered employee" is defined as any one of the five highest compensated employees of an ATEO either (i) for the current taxable year or (ii) for any year beginning after December 31, 2016. Licensed medical or veterinarian professionals, however, are excluded from the definition of "covered employee." New § 4960 is permanent and effective for taxable years beginning after 2017. Given that many tax-exempt organizations have taxable years ending June 30 or October 31, many potentially affected organizations will have time to either comply or attempt to avoid new § 4960.

a. **The probable NCAA "airball."** Congress apparently thought that new § 4960 defined an ATEO so that both public and private colleges and universities would have to pay the 21 percent excise tax on compensation exceeding $1 million. The legislative history accompanying § 4960 states: "An [ATEO] is an organization exempt from tax under section 501(a), an exempt farmers' cooperative, *a Federal, State or local governmental entity with excludable income*, or a political organization." *See* H.R. Conf. Rep. No. 115-466, at 492 (Dec. 15, 2017) (emphasis added). At least one well-respected exempt organization scholar, however, has pointed out that, at least according to the IRS, "[i]ncome earned by a state, a political subdivision of a state, or an integral part of a state or political subdivision of a state" is not taxable regardless of § 115, citing Rev. Rul. 87-2, 1987-1 C.B. 18. Instead, it is the IRS's position that public colleges and universities are not taxable under our federalist system unless and until Congress enacts a specific statutory provision subjecting such state-affiliated organizations to tax like § 511(a)(2)(B) (state colleges and universities are subject to unrelated business income tax). *See* the blog post by Professor Ellen P. Aprill here, and her full law review article on the subject: Ellen P. Aprill, *The Integral, the Essential, and the Instrumental: Federal Income Tax Treatment of Government Affiliates*, 23 J. Corp. Law 803 (1997).

b. And another thing … Churches are exempt from taxation under § 501(a) along with hospitals and private schools. But we wouldn't bet money that any church paying its pastor more than $1 million annually is going to pay an excise tax under new § 4960 without a fight based on the First Amendment. Ultimately, the church may lose such a fight because it is clear that churches are subject to the unrelated business income tax of § 511, but if a church can pay its pastor $1 million a year, it can pay a tax lawyer to litigate too.

c. Interim guidance on the § 4960 21 percent excise tax on applicable tax-exempt organizations. Notice 2019-9, 2019-__ I.R.B. __ (12/31/18). In this notice, the IRS announced that Treasury and the IRS will issue proposed regulations under § 4960, the provision enacted by the 2017 Tax Cuts and Jobs Act that imposes an excise tax at the highest rate in § 11 (currently 21 percent) on "applicable tax-exempt organizations" ("ATEOs") and broadly-defined "related organizations" paying over $1 million annually to "covered employees." The notice provides, in Q&A format, extensive interim guidance on new § 4960. Until further guidance is issued, taxpayers may base their positions upon a good faith, reasonable interpretation of § 4960, including its legislative history, to comply with the requirements of the statute. The notice provides that the positions reflected in it constitute a good faith, reasonable interpretation of the statute. The preamble to the notice describes certain positions that will be regarded as not consistent with a good faith, reasonable interpretation of the statutory language. Among other guidance, the notice provides in Q&A 5 that public universities with IRS determination letters recognizing their tax-exempt status under § 501(c)(3) *are* ATEOs and therefore subject to § 4960, but "a governmental unit (including a state college or university) that does not have a determination letter recognizing its exemption from taxation under section 501(a) and does not exclude income from gross income under section 115(1) is not an ATEO" and therefore is not subject to § 4960. Nevertheless, the notice provides that such a governmental unit may be liable for the excise tax imposed by § 4960 if it is a related organization under § 4960(c)(4)(B) with respect to an ATEO.

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

B. Charitable Giving

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. Updated instructions on how to rat yourself out. Rev. Proc. 2019-9, 2019-2 IRB 292 (12/20/18). This revenue procedure updates Rev. Proc. 2018-11, 2018-5 I.R.B. 335 (1/26/18), and identifies circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under § 6662(d), relating to the substantial understatement aspect of the accuracy-related penalty, and for the purpose of avoiding the tax return preparer penalty under § 6694(a), relating to understatements due to unreasonable positions. There have been no substantive changes. The revenue procedure does not apply with respect to any other penalty provisions, including § 6662(b)(1) accuracy-related penalties. If this revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275–R, as appropriate, attached to the return for the year or to a qualified amended return. A corporation's complete and accurate disclosure of a tax position on the appropriate year's Schedule UTP, Uncertain Tax Position Statement, is treated as if the corporation had filed a Form 8275 or Form 8275-R regarding the tax position. The revenue procedure applies to any income tax return filed on a 2018 tax form for a taxable year beginning in 2018 and to any income tax return filed on a 2018 tax form in 2019 for a short taxable year beginning in 2019.

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

XII. TAX LEGISLATION

XIII. TRUSTS, ESTATES & GIFTS