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

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E. Depreciation & Amortization

1. The IRS comes to the rescue to allow depreciation of passenger automobiles that qualify for 100 percent bonus depreciation under § 168(k). Rev. Proc. 2019-13, 2019-9 I.R.B. (2/13/19). Under § 280F(a)(1)(B)(i), the "unrecovered basis" of a passenger automobile that is subject to the § 280F limits on depreciation is treated as an expense for the first taxable year after the automobile's recovery period. For passenger automobiles eligible for 100 percent first year depreciation under § 168(k), the amount by which the cost of the vehicle (before any § 179 deduction) exceeds the first year § 280F limitation is the "unrecovered basis" for purposes of § 280F(a)(1)(B)(i). In other words, if a taxpayer does not elect out of 100 percent first-year bonus depreciation, then the taxpayer can deduct in the year the vehicle is placed in service the maximum amount allowed under § 280F(a)(1)(A) and then cannot deduct any additional portion of the vehicle's cost until after the recovery period has passed, at which point the taxpayer can deduct the unrecovered cost as an expense, subject to the annual $5,670 limitation specified in § 280F(a)(1)(B)(ii). The revenue procedure gives the following example:

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

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

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

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

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

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

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

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

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

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

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

Examples. The revenue procedure gives the following examples.

> <u>Example 1 - Application of § 280F(a) safe harbor method of accounting</u>. In 2018, X, a calendar-year taxpayer, purchased and placed in service for use in its business a new passenger automobile that costs $60,000. The passenger automobile is 5-year property under § 168(e), is qualified property under § 168(k) for which the 100-percent additional first year depreciation deduction is allowable, and is used 100 percent in X's trade or business. X does not claim a § 179 deduction for the passenger automobile and does not make an election under § 168(b), (g)(7), or (k). X depreciates the passenger automobile under the general depreciation system by using the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. X adopts the safe harbor method of accounting provided in section 4.03 of this revenue procedure. As a result:
>
> > (a) X must use the applicable optional depreciation table that corresponds with the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention, for determining the depreciation deductions for the passenger automobile (see Table A-1 in Appendix A of IRS Publication 946);
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> > (b) For 2018, X deducts depreciation of $18,000 for the passenger automobile, which is the depreciation limitation for 2018 under § 280F(a)(1)(A)(i) (see Table 2 in Rev. Proc. 2018-25). As a result, the remaining adjusted depreciable basis of the passenger automobile as of January 1, 2019, is $42,000 ($60,000 unadjusted depreciable basis less $18,000 depreciation deduction claimed for 2018);
> >
> > (c) For 2019 through 2023, the total depreciation allowable for the passenger automobile for each taxable year is determined by multiplying the annual depreciation rate in the applicable optional depreciation table by the remaining adjusted depreciable basis of $42,000, subject to the limitation under

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

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

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

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

<u>Example 2 – Section 179 deduction claimed</u>. The facts are the same as in <u>Example 1</u>, except X elects to treat $18,000 of the cost of the passenger automobile as an expense under § 179. As a result, this passenger automobile is not within the scope of this revenue procedure pursuant to section 3.01(4) of this revenue procedure. Accordingly, the safe harbor method of accounting in section 4.03 of this revenue procedure does not apply to the passenger automobile. For 2018, the 100-percent additional first year depreciation deduction and the § 179 deduction for this passenger automobile is limited to $18,000 under § 280F(a)(1)(A)(i) (see Table 2 of Rev. Proc. 2018-25). Therefore, for 2018, X deducts $18,000 for the passenger automobile under § 179, and X deducts the excess amount of $42,000 beginning in 2024, subject to the annual limitation of $5,760 under § 280F(a)(1)(B)(ii).

<u>Example 3 – Section 168(k)(7) election made</u>. The facts are the same as in <u>Example 1</u>, except X makes an election under § 168(k)(7) to not claim the 100-percent additional first year depreciation deduction for 5-year property placed in service during 2018. As

a result, the 100-percent additional first year depreciation deduction is not allowable for the passenger automobile. Accordingly, the passenger automobile is not within the scope of this revenue procedure pursuant to section 3.01(2) of this revenue procedure, and the safe harbor method of accounting in section 4.03 of this revenue procedure does not apply to the passenger automobile. For 2018 and subsequent taxable years, X determines the depreciation deductions for the passenger automobile in accordance with the general depreciation system of § 168(a), subject to the § 280F(a) limitations.

F. Credits

G. Natural Resources Deductions & Credits

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III. INVESTMENT GAIN AND INCOME

IV. COMPENSATION ISSUES

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VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

C. Liquidations

D. S Corporations

1. In line with the continuing expansion of eligible shareholders of subchapter S corporations, ESBTs now may have non-U.S. individuals as current beneficiaries. The 2017 Tax Cuts and Jobs Act, § 13541, makes a technical change to § 1361(c)(2)(B)(v) such that for 2018 and future years an "electing small business trust" (an "ESBT," as particularly defined in § 1361(e)) may have as a current beneficiary of the ESBT a "nonresident alien" individual. Under § 7701(b)(1)(B), a nonresident alien individual is someone who is neither a citizen nor a resident of the U.S. This change to § 1361 is permanent.

a. Proposed regulations address the treatment of ESBTs that are S corporation shareholders and have nonresident aliens as beneficiaries. REG-117062-18, Electing Small Business Trusts With Nonresident Aliens as Potential Current Beneficiaries, 84 F.R. 16415 (4/19/19). The Treasury Department and the IRS have issued proposed regulations addressing the treatment of electing small business trusts that are S corporation shareholders and have nonresident aliens as beneficiaries. The preamble to the proposed regulations notes the apparent assumption in the legislative history of the 2017 Tax Cuts and Jobs Act that an ESBT is subject to tax and therefore would be subject to tax on the ESBT's share of the S corporation's income. The preamble notes, however, that ESBTs can be grantor trusts for federal tax purposes with the result that the beneficiaries of the ESBT, not the ESBT itself, are subject to tax on the S corporation's income. If a nonresident alien is a beneficiary of an ESBT, this could lead to the S corporation's income not being subject to U.S. taxation (e.g., if the income is foreign-source). Therefore, according to the premable, the proposed regulations generally

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

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

E. Mergers, Acquisitions and Reorganizations

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

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

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

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

VII. PARTNERSHIPS

A. Formation and Taxable Years

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

C. Distributions and Transactions Between the Partnership and Partners

D. Sales of Partnership Interests, Liquidations and Mergers

E. Inside Basis Adjustments

F. Partnership Audit Rules

1. The partnership audit rules do not apply to special enforcement matters. Notice 2019-6, 2019-3 I.R.B. (12/20/18). In this notice, the Treasury Department and the IRS announced that proposed regulations will be issued to address certain "special enforcement matters" under § 6241(11). The notice also requests comments regarding other special enforcement matters that could be the subject of future proposed regulations. Congress added § 6241(11) to the Code as part of the Consolidated Appropriations Act, 2018, Pub. L. No. 115-141, Division U, Title II, §§ 201-207, ("CAA 2018"), signed by the President on March 23, 2018, which enacted a number of technical corrections to the partnership audit rules that became effective for partnership taxable years beginning after 2017.

Section 6241(11). Section 6241(11) provides that, in the case of partnership-related items that involve special enforcement matters, the Secretary of the Treasury may issue regulations providing that (1) the partnership audit rules (or a portion of the rules) do not apply to the partnership-related items, and (2) the partnership-related items are subject to special rules (including rules related to assessment and collection) that the Secretary of the Treasury determines to be necessary for the effective and efficient enforcement of the Code. Section 6241(11) lists several specific special enforcement matters, including criminal investigations, indirect methods of proof of income, and foreign partners or partnerships, and also provides in § 6241(11)(vi) that special enforcement matters include "other matters that the Secretary determines by regulation present special enforcement considerations."

Notice 2019-6. The notice provides that proposed regulations will be issued under § 6241(11)(vi) regarding two matters that present special enforcement considerations. The **first** matter is when an adjustment during an examination of a person other than the partnership requires a change to a partnership-related item. Specifically, the proposed regulations will provide that the IRS may determine that the partnership audit rules do not apply if the following three conditions are satisfied: (1) the examination being conducted is of a person other than the partnership, (2) a partnership-related item must be adjusted (or a determination regarding a partnership-related item must be made) as part of an adjustment to a non-partnership-related item of the person whose return is being examined, and (3) the treatment of the partnership-related item on the return of the partnership (or in the partnership's books and records) was based in whole or in part on information provided by, or under the control of, the person whose return is being examined. The notice provides that this rule

> will allow the IRS to effectively and efficiently focus on a single partner or a small group of partners with respect to a limited set of partnership-related items without unduly burdening the partnership and avoiding procedural concerns about the appropriate level at which such items must be examined.

The **second** matter is when a qualified subchapter S subsidiary (QSub) is a partner in a partnership. According to the notice, the proposed regulations will provide that the ability of partnerships with 100 or fewer partners to elect out of the partnership audit regime under § 6221(b) generally does not apply to a partnership with a QSub as a partner. Nevertheless, under the forthcoming proposed regulations, a partnership with a QSub as a partner will be able to elect out of the partnership audit regime if it meets certain requirements. The rule concerning the ability to elect out will be similar to the rule of § 6221(b)(2)(A) that currently applies to a partnership with an S corporation as a partner. Section 6221(b)(2)(A) provides that a partnership with an S corporation as a partner can elect out of the partnership audit regime only if it discloses with its return for the year the name and taxpayer identification number of each person with respect to whom the S corporation is required to furnish a Schedule K-1 and counts each of the S corporation's Schedule K-1s in determining whether the partnership has 100 or fewer partners. Accordingly, the forthcoming proposed regulations will provide that, for purposes of determining whether a partnership has 100 or fewer partners for purposes of electing out under § 6221(b), the partnership must include (1) the statement (Schedule K-1) the partnership is required to furnish to the QSub partner under § 6031(b), and (2) each statement (Schedule K-1) the S corporation that holds 100 percent of the stock of the QSub partner is required to furnish to its shareholders under § 6037(b).

Effective Date. The notice provides that Treasury and the IRS intend to issue the proposed regulations within eighteen months of the enactment of Consolidated Appropriations Act, 2018, Pub. L. No. 115-141, which was enacted on March 23, 2018. Pursuant to § 7805(b)(2), the effect of issuing the proposed regulations in this period will be that the regulations will apply to all partnership taxable years beginning after 2017. The notice also provides that, if the proposed regulations are not issued within this eighteen-month period, then the regulations will apply to partnership taxable years beginning after 2017 and ending after December 20, 2018, the date on which the notice was issued to the public.

G. Miscellaneous

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

a. No good deed goes unpunished. Ginsburg v. United States, 136 Fed. Cl. 1 (1/31/18). In this decision, the Court of Federal Claims held that the State of New York's payment of approximately $1.8 million to an LLC (taxed as a partnership) to incentivize and reward redevelopment of brownfield property is includable in the taxpayer-member's gross income. The taxpayer owned 90% of an LLC taxed as a partnership for federal income tax purposes. The taxpayer's LLC participated in New York's Brownfield Development Tax Credit program in connection with acquiring an abandoned shoe factory in 2004 and eventually restoring it as a 134-unit residential building by 2011. New York's Brownfield Tax Credit program allows certain credits against state income taxes based upon investment in qualifying brownfield property. Further, if the credit is fully used by a taxpayer to offset applicable New York state income taxes, the excess of the credit over the amount used against state income taxes is paid to the taxpayer. Accordingly, after certifying that the taxpayer's LLC had complied with the terms of the Brownfield Development Tax Credit program, in 2013 New York paid the taxpayer's LLC approximately $1.8 million in satisfaction of the taxpayer's excess credit amount. The taxpayer took the position on his 2013 federal income tax return that his 90% allocable share of the $1.8 million payment was excludable from gross income as a nontaxable capital contribution to the LLC. (New York law allowed exclusion of the payment for New York income tax purposes.) Upon audit, the Service determined that the payment constituted gross income to the LLC and thus to the taxpayer as part of his allocable share of partnership income. This adjustment resulted in additional gross income to the taxpayer for 2013 and a corresponding underpayment of approximately $602,000. The taxpayer paid the underpayment, filed a refund claim, and then brought this action in the Court of Federal Claims.

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

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

b. Yet again, no good deed goes unpunished. But perhaps there could have been a workaround? Uniquest Delaware, LLC v. United States, 294 F. Supp. 3d 107 (W.D.N.Y. 3/27/18). In this decision, the U.S. District Court for the Western District of New York held that a grant paid by the New York State Empire State Development Corporation (which appears to have been a government-funded corporation) to an LLC taxed as a partnership was not excludable from the LLC's gross income as a contribution to capital. The taxpayer in this case was the LLC (unlike *Ginsburg v. United States*, 136 Fed. Cl. 1 (1/31/18), in which the taxpayer was a partner-member of the LLC). The LLC, a TEFRA partnership, had two equal members, each of which was a disregarded single-member LLC, that in turn were each wholly-owned by separate subchapter S corporations. The case arose in connection with a TEFRA partnership audit of the LLC, a fact which was important to the court's ultimate decision (as explained further below). In 2009, the LLC received an $11 million grant from the New York State Empire State Development Corporation for the restoration of a building in Buffalo. The original grant proposal expressly stated that "[t]here is no element of compensation of specific, quantifiable or other services to the government agencies involved; the grants contemplated by this offer are being offered solely for the purpose of obtaining an advantage for the general community." The LLC did not include the $11 million grant in its income on its partnership tax return for 2009. During the audit and at Service Appeals, the Service asserted that the $11 million grant was included in the LLC's gross income in 2009 and ultimately issued an FPAA accordingly. The taxpayer-LLC then sought judicial review of the FPAA in the U.S. District Court for the Western District of New York.

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

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

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

c. The Federal Circuit has affirmed the Claims Court's decision that an LLC classified as a tax partnership could not exclude from gross income a cash payment received from the State of New York. Ginsburg v. United States, 123 A.F.T.R.2d ¶ 2019-652 (Fed. Cir. 4/25/19), *aff'g* 136 Fed. Cl. 1 (1/31/18). In an opinion by Judge Wallach, the U.S. Court of Appeals for the Federal Circuit has affirmed the decision of the U.S. Court of Federal Claims granting summary judgment to government and held that an LLC classified as a partnership had to include in gross income a cash payment received from the State of New York. As a result, the members of the LLC, including the taxpayers in this case, had to include their distributive shares of the payment in gross income. The taxpayer owned 90% of an LLC taxed as a partnership for federal income tax purposes. The taxpayers held 90 percent of the memebrship interests in an LLC that participated in New York's Brownfield Development Tax Credit program in connection with acquiring an abandoned shoe factory in 2004 and eventually restoring it as a 134-unit residential building by 2011. Under this program, if the credit is fully used by a taxpayer to offset applicable New York state income taxes, the excess of the credit over the amount used against state income taxes is paid to the taxpayer. After certifying that the taxpayers' LLC had complied with the terms of the Brownfield Development Tax Credit program, in 2013 New York paid the taxpayer's LLC approximately $1.8 million in satisfaction of the taxpayer's excess credit amount. The taxpayers took the position on their 2013 federal income tax return that their 90% allocable share of the $1.8 million payment was excludable from gross income as a nontaxable capital contribution to the LLC. Following an audit, the taxpayers paid the underpayment asserted by the IRS of approximately $602,000, filed a refund claim, and then brought a refund action in the Court of Federal Claims, which held that the payment constituted gross income. On appeal, the Federal Circuit first concluded that the funds received were an economic gain over which the taxpayers had complete dominion and therefore constituted gross income under the taxpayers had gross income under *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). The court rejected all of the taxpayer's arguments that the payments were excludable from income, including the arguments that: (1) the payment for the excess amount was a nontaxable return of capital, and (2) the brownfield redevelopment tax credit was "'indistinguishable from . . . inducement payments, rebates, and reimbursements that' have historically been treated as 'not includable in gross income.'"

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. All hardship exemptions, including a general hardship exemption, from the requirement to maintain minimum essential coverage can be claimed on an individual's tax return for 2018. Notice 2019-5, 2019-2 I.R.B. 283 (12/21/18). Under § 5000A, for months beginning after December 31, 2014, an individual must maintain minimum essential coverage and must pay a penalty (the individual shared responsibility payment) for failure to do so unless the person qualifies for an exemption. Some exemptions can be claimed only if an individual has obtained a hardship exemption certification from the Health Insurance Marketplace. Others can be claimed on the individual's federal income tax return. This notice supplements Notice 2014-76, 2014-50 I.R.B. 946, as supplemented by Notice 2017-14, 2017-6 I.R.B. 783, both of which provided that certain hardship exemptions could be claimed on an individual's tax return. Specifically, this notice reflects guidance issued by the Department of Health and Human Services on September 12, 2018, which provides that all hardship exemptions available under 45 C.F.R. § 155.605(d)(1), including a general hardship exemption, can be claimed on an individual's federal income tax return. These hardship exemptions are:

1. "He or she experienced financial or domestic circumstances, including an unexpected natural or human-caused event, such that he or she had a significant, unexpected increase in essential expenses that prevented him or her from obtaining coverage under a qualified health plan;"
2. "The expense of purchasing a qualified health plan would have caused him or her to experience serious deprivation of food, shelter, clothing, or other necessities; or"
3. "He or she has experienced other circumstances that prevented him or her from obtaining coverage under a qualified health plan."

- The 2017 Tax Cuts and Jobs Act, § 11081, amended Code § 5000A(c) to reduce to zero the penalty enacted as part of the Affordable Care Act for failing to maintain minimum essential coverage. This change applies to months beginning after 2018.

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

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

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

F. Liens and Collections

G. Innocent Spouse

1. Even a Johnny Cash song couldn't have told a story like this. A taxpayer prevails in her quest for innocent spouse relief. Contreras v. Commissioner, T.C. Memo. 2019-12 (2/26/19). The taxpayer sought innocent spouse relief under § 6015(f) with respect to the years 2006 through 2009. The taxpayer married her husband in August of 2000. He had his own home construction business and she stayed home to care for their two children and her husband's two children from a prior relationship. They lived in a mobile home on property in Liberty County, Texas (Lot 12) and planned to build a home on the lot next door, Lot 13. When they applied for financing to assist with construction, the taxpayer learned that Lot 13 was owned by her husband and the woman with whom he had previously been in a relationship. She and her husband were advised by an attorney that her husband was still in a common law marriage with the other woman and that, to remove the other woman's name from the title to Lot 13, her husband would have to go through a divorce proceeding, which he did. This necessarily meant that, when the taxpayer had married her husband, he was already married and therefore the taxpayer had never been legally married to her husband. Ultimately, her husband built the house on Lot 13, largely using materials left over from various jobs of his home construction company, and the family moved into the home. During the course of their relationship, the taxpayer's husband was abusive and routinely came home in a drunken state. The police were called to their home on several occasions. When the taxpayer's husband came home in a drunken state, she and her husband argued and on various occasions her husband kicked in a bedroom door, damaged property, threw the taxpayer's possessions out outside the home, and committed other aggressive acts. On these occasions, the taxpayer often left the home with her children to go to the home of her grandmother. The taxpayer's husband had at least one affair with another woman during their marriage. Her husband handled filing of their federal income tax returns. No returns were filed for the year 2006 through 2009. She was divorced from her husband in 2011. The decree of divorce awarded each spouse as separate property a one-half interest in Lots 12 and 13. In addition, the divorce decree awarded the taxpayer $127,050 and authorized the taxpayer to foreclose on her ex-husband's interest in Lots 12 and 13 if he did not pay this amount by a specified date. Her ex-husband failed to pay this amount and voluntarily transferred to the taxpayer his interests in Lots 12 and 13. The deed transferring title was prepared with the assistance of an attorney and recorded in the public land records. Just prior to their divorce, the IRS filed a notice of lien against her husband and, just after the divorce, the U.S. Department of Justice brought an action in the U.S. District Court seeking to reduce tax liabilities to judgment and to foreclose on the home in which the taxpayer lived with her two children. Following their divorce, the taxpayer's ex-husband filed returns for 2008 and 2009 with the filing status of head-of-household. In 2013, in connection with an IRS audit of the years 2006 through 2009, the taxpayer signed joint returns for 2006 and 2007 as well as amended returns for 2008 and 2009 that were joint returns. She placed the words "as to form" next to her signature on the 2006 and 2007 returns. She repeatedly expressed that she did not understand the returns and did not understand why she had to sign a joint return with her ex-husband. She was represented in the course of the audit by an attorney whose fees were paid by her ex-husband. The IRS sought to hold the taxpayer liable for nearly $300,000 in taxes, penalties and interest for the years 2006 through 2009. The taxpayer filed an administrative request for innocent spouse relief, which the IRS denied. The taxpayer then filed a petition in the Tax Court. The Tax Court (Judge Paris) held that the taxpayer was entitled to innocent spouse relief under § 6515(f) (equitable relief) with respect to all of the years at issue. The taxpayer and the IRS agreed that the taxpayer met all threshold requirements for equitable relief under Rev. Proc. 2013-34, 2013-43 I.R.B. 397 except for one. The IRS asserted that assets (Lots 12 and 13) had been transferred between the spouses as part of a fraudulent scheme. The court rejected this argument largely on the basis that the transfer was made pursuant to rights granted to the taxpayer in the divorce decree and that the taxpayer and her husband had recorded the transfer in the public land records and therefore had not attempted to conceal the transfer. The court also rejected the IRS's arguments that the taxpayer was not entitled to streamlined relief under Rev. Proc. 2013-34. The IRS argued that the taxpayer would not suffer economic hardship if relief were not granted, which the court rejected on the basis that the taxpayer's only source of income consisted of child support payments, which were not reliable, and government assistance. The IRS also argued that the taxpayer was not entitled to streamlined relief because she had knowledge that her ex-husband would not or could not pay the liabilities in question. The court rejected this argument based on the taxpayer's credible testimony (as well as that of her daughter) regarding her ex-husband's abusive and controlling behavior.

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

H. <u>Miscellaneous</u>

XI. <u>WITHHOLDING AND EXCISE TAXES</u>

XII. <u>TAX LEGISLATION</u>

XIII. <u>TRUSTS, ESTATES & GIFTS</u>