RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

We apologize to our readers. If we had more time, this outline would be much shorter.

By

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State Bar of Texas
First Wednesday Tax Update
September 2, 2020

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I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

C. Reasonable Compensation

D. Miscellaneous Deductions

1. 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) In General.**—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. 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).

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 ($265 for 2019 and $270 for 2020), 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 a deduction for an expense relating to goods, services, and facilities to the extent the taxpayer treats the expense as wages paid 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.

b. Who knew that determining the tax consequences of providing parking or transportation to employees could get so complicated? Proposed regulations address determining the nondeductible portion of qualified transportation fringe benefits. REG-119307-19, Qualified Transportation Fringe, Transportation and Commuting Expenses Under Section 274, 85 F.R. 37599 (6/23/20). These proposed regulations implement two legislative changes made by section 13304(c) of the 2017 Tax Cuts and Jobs Act, which added § 274(a)(4) and § 274(*l*) to the Code. Section 274(a)(4) disallows the deduction of any "qualified transportation fringe" (as defined in § 132(f)) provided to an employee of the taxpayer in taxable years beginning after 2017. 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. Section 274(*l*) disallows the deduction of 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, but does not disallow any qualified bicycle commuting reimbursement (as described in section 132(f)(5)(F)) paid or incurred after 2017 and before 2026.

Disallowance of deductions for qualified transportation fringe benefits. Prop. Reg. § 1.274-(13) provides rules implementing the § 274(a)(4) disallowance of deductions for qualified transportation fringe benefits. With respect to qualified parking provided to employees, the proposed regulations follow the approach of Notice 2018-99 in distinguishing between employers who pay a third party to permit employees to park at the third party's parking lot or garage and employers who own or lease all or a portion of a parking facility. The proposed regulations, however, refine and expand the guidance provided in Notice 2018-99 by, among other things, defining a number of key terms (such as the terms "employee" and "total parking expenses") and providing simplified methodologies that employers who own or lease parking facilities can use to determine the nondeductible portion of their parking expenses. Further, the proposed regulations address the treatment of so-called "mixed parking expenses," which are amounts paid or incurred by a taxpayer that include both nonparking and parking facility expenses, such as lease payments that entitle the employer to use both office space and spaces in a parking garage. The proposed regulations also permit employers that own or lease parking facilities to aggregate parking spaces within a single geographic location (defined as contiguous tracts or parcels of land owned or leased by the taxpayer) for certain purposes.

Employer Pays a Third Party for Employee Parking Spots. According to Prop. Reg. § 1.1.274-13((d)(1), 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, under Code § 274(e)(2) and Prop. Reg. 1.274-13(e)(1), the disallowance of deductions for qualified transportation fringes does not apply to an expense relating to goods, services, and facilities to the extent the taxpayer treats the expense as wages paid to its employees. Accordingly, if the amount paid by the employer exceeds the § 132(f)(2) monthly limitation on the employee's exclusion ($265 for 2019 and $270 for 2020), the employer must treat the excess amount as compensation and wages to the employee. The excess amount is not disallowed as a deduction provided that the employer treats the expense both as compensation on its federal income tax return and as wages subject to withholding. 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 Prop. Reg. § 1.274-13(e)(3).

Taxpayer Owns or Leases All or a Portion of a Parking Facility. Under Prop. Reg. § 1.274-13(d)(2), 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 either a general rule or one of three simplified methodologies. Under the general rule, an employer can determine the nondeductible portion of parking expenses "based on a reasonable interpretation of section 274(a)(4)." A method will not be treated as based on a reasonable interpretation if it uses the *value* of parking provided to employees to determine parking expenses (because § 274(a)(4) disallows a deduction for the *expense* of providing a qualified transportation fringe), results in deducting expenses related to reserved employee spaces, or improperly applies the exception in § 274(e)(7) for qualified parking made available to the public (e.g., by treating a parking facility regularly used by employees as available to the public merely because the general public has access to the parking facility). There are three simplified methodologies than a taxpayer can use as an alternative to the general rule. *First*, a taxpayer can use the "qualified parking limit methodology," which determines the disallowed portion of parking costs by multiplying the § 132(f)(2) monthly limitation on the employee's exclusion ($265 for 2019 and $270 for 2020) for each month in the taxable year by the total number of spaces used by employees during the "peak demand period" (a defined term) or by number of employees. For example, an employer with 10 employees who provides parking to all of them each day for the full year would have $32,400 in disallowed parking costs (10 * $270 *12) for the year. This method is illustrated by example 3 in Prop. Reg. § 1.274-13(e)(3). *Second*, a taxpayer can use the "primary use methodology," which is essentially the same as the four-step methodology provided in Notice 2018-99 that, according to the notice, is deemed to be a reasonable method of determining the nondeductible portion of parking costs. 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 exclusively for employees 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, the taxpayer must reasonably allocate the remaining expenses by determining "the total number of available parking spaces used by employees during the peak demand period." This four-step methodology is illustrated by examples 4 through 9 in Prop. Reg. § 1.274-13(e)(3). *Third*, a taxpayer can use the "cost per space methodology," which determines the disallowed portion of parking costs by multiplying the employer's cost per space (total parking expenses divided by total parking spaces) by the total number of available parking spaces used by employees during the peak demand period. As defined in Prop. Reg. § 1.274-13(b)(12), the term "*total parking expenses*," a portion of which is disallowed, includes, 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 (if not broken out separately)." However, the term total parking expenses does *not* include a deduction for depreciation on a parking facility used for parking by the taxpayer's employees.

Disallowance of non-QTF expenses incurred for employee travel from residence to place of employment. Prop. Reg. § 1.274-14 implements the §274(*l*) disallowance of deductions for expenses incurred for providing transportation (or a payment o reimbursement) to an employee in connection with the employee's travel between the employee's residence and place of employment. This disallowance does not apply if the transportation or commuting expense is necessary to endure the safety of the employee. The disallowance also does not apply to qualified transportation fringes, which must be analyzed under the rules previously discussed. This proposed regulation is very brief and provides no examples.

Effective dates. According to Prop. Reg. §§ 1.274-13(g) and § 1.274-14(c), the proposed regulations will apply for taxable years that begin on or after the date on which the final regulations are published in the Federal Register. The preamble adds that, until final regulations are issued, taxpayers can rely on the proposed regulations or, alternatively, can rely on the guidance in Notice 2018-99.

E. Depreciation & Amortization

F. Credits

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H. Loss Transactions, Bad Debts, and NOLs

I. At-Risk and Passive Activity Losses

III. INVESTMENT GAIN AND INCOME

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V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

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

D. Deductions and Credits for Personal Expenses

1. Has the federal deduction for your high property or state income taxes made them easier to bear? Brace yourself! The deduction for state and local taxes not paid or accrued in carrying on a trade or business or an income-producing activity is limited to $10,000. The 2017 Tax Cuts and Jobs Act, § 11042, amended Code § 164(b) by adding § 164(b)(6). For individual taxpayers, this provision generally (1) eliminates the deduction for foreign real property taxes, and (2) limits to $10,000 ($5,000 for married individuals filing separately) a taxpayer's itemized deductions on Schedule A for the aggregate of state or local property taxes, income taxes, and sales taxes deducted in lieu of income taxes. This provision applies to taxable years beginning after 2017 and before 2026. The provision does not affect the deduction of state or local property taxes or sales taxes that are paid or accrued in carrying on a trade or business or an income-producing activity (i.e., an activity described in § 212) that are properly deductible on Schedules C, E, or F. For example, property taxes imposed on residential rental property will continue to be deductible. With respect to income taxes, an individual can deduct only foreign income taxes paid or accrued in carrying on a trade or business or an income-producing activity. As under current law, an individual cannot deduct state or local income taxes as a business expense even if the individual is engaged in a trade or business as a sole proprietor. See Reg. § 1.62-1T(d).

a. The IRS is not going to give blue states a pass on creative workarounds to the new $10,000 limitation on the personal deduction for state and local taxes. Notice 2018-54, 2018-24 I.R.B. 750 (05/23/18). In response to new § 164(b)(6), many states—including Connecticut, New Jersey, and New York—have enacted workarounds to the $10,000 limitation. For instance, New Jersey reportedly has enacted legislation giving property owners a special tax credit against otherwise assessable property taxes if the owner makes a contribution to charitable funds designated by local governments. Connecticut reportedly has enacted a new provision that taxes the income of pass-through entities such as S corporations and partnerships, but allows the shareholders or members a corresponding tax credit against certain state and local taxes assessed against them individually. Notice 2018-54 announces that the IRS and Treasury are aware of these workarounds and that proposed regulations will be issued to "make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers." In other words, blue states, don't bank on a charitable contribution or a flow-through income tax substituting for otherwise assessable state and local taxes to avoid new § 164(b)(6). The authors predict that this will be an interesting subject to watch over the coming months.

b. Speaking of looming trouble spots: The availability of a business expense deduction under § 162 for payments to charities is not affected by the recently issued proposed regulations, says the IRS. IRS News Release IR-2018-178 (9/5/18). This news release clarifies that the availability of a deduction for ordinary and necessary business expenses under § 162 for businesses that make payments to charities or government agencies and for which the business receives state tax credits is not affected by the proposed regulations issued in August 2018 that generally disallow a federal charitable contribution deduction under § 170 for charitable contributions made by an individual for which the individual receives a state tax credit. See REG-112176-18, Contributions in Exchange for State and Local Tax Credits, 83 F.R. 43563 (8/27/18). Thus, if a payment to a government agency or charity qualifies as an ordinary and necessary business expense under § 162(a), it is not subject to disallowance in the manner in which deductions under § 170 are subject to disallowance. This is true, according to the news release, regardless of whether the taxpayer is doing business as a sole proprietor, partnership or corporation. According to a "frequently asked question" posted on the IRS website, "a business taxpayer making a payment to a charitable or government entity described in § 170(c) is generally permitted to deduct the entire payment as an ordinary and necessary business expense under § 162 if the payment is made with a business purpose."

c. More about trouble spots: The IRS must be thinking, "Will this ever end?" Rev. Proc. 2019-12, 2019-04 I.R.B. 401 (12/29/18). Notwithstanding the above guidance, Treasury and the IRS obviously have continued to receive questions regarding the deductibility of business expenses that may indirectly bear on the taxpayer's state and local tax liability. In response, Rev. Proc. 2019-12 provides certain safe harbors. For C corporations that make payments to or for the use of § 170(c) charitable organizations and that receive or expect to receive corresponding tax credits against state or local taxes, the C corporation nevertheless may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of § 162(a). A similar safe harbor rule applies for entities other than C corporations, but only if the entity is a "specified passthrough entity." A specified passthrough entity for this purpose is one that meets four requirements. First, the entity must be a business entity other than a C corporation that is regarded for all federal income tax purposes as separate from its owners under Reg. § 301.7701-3 (i.e., it is not single-member LLC). Second, the entity must operate a trade or business within the meaning of § 162. Third, the entity must be subject to a state or local tax incurred in carrying on its trade or business that is imposed directly on the entity. Fourth, in return for a payment to a § 170(c) charitable organization, the entity receives or expects to receive a state or local tax credit that the entity applies or expects to apply to offset a state or local tax imposed upon the entity. The revenue procedure applies to payments made on or after January 1, 2018.

C corporation example state and local income tax credit: A, a C corporation engaged in a trade or business, makes a payment of $1,000 to a § 170(c) charitable organization. In return for the payment, A receives or expects to receive a dollar-for-dollar state tax credit to be applied to A's state corporate income tax liability. Under the revenue procedure, A may treat the $1,000 payment as meeting the requirements of an ordinary and necessary business expense under § 162.

C corporation example state and local property tax credit: B, a C corporation engaged in a trade or business, makes a payment of $1,000 to a § 170(c) charitable organization. In return for the payment, B receives or expects to receive a tax credit equal to 80 percent of the amount of this payment ($800) to be applied to B's local real property tax liability. Under the revenue procedure, B may treat $800 as meeting the requirements of an ordinary and necessary business expense under § 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by the revenue procedure. (In other words, the $200 could be a charitable contribution deductible under § 170, or the $200 could be a business expense deductible under § 162.)

Specified passthrough example state and local property tax credit: S is an S corporation engaged in a trade or business and is owned by individuals C and D. S makes a payment of $1,000 to a § 170(c) charitable organization. In return for the payment, S receives or expects to receive a state tax credit equal to 80 percent of the amount of this payment ($800) to be applied to S's local real property tax liability incurred by S in carrying on its trade or business. Under applicable state and local law, the real property tax is imposed at the entity level (not the owner level). Under the revenue procedure, S may treat $800 of the payment as meeting the requirements of an ordinary and necessary business expense under § 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by this revenue procedure. (In other words, the $200 could be a charitable contribution deductible under § 170 by the owners of the specified passthrough entity, or the $200 could be a business expense deductible at the entity level under § 162.)

d. And like Rameses II in The Ten Commandments, Treasury says, "So let it be written; so let it (finally!) be done." T.D. 9864, Contributions in Exchange for State or Local Tax Credits, 84 F.R. 27513 (6/13/19). The Treasury Department and the IRS have finalized, with only minor changes, proposed amendments to the regulations under § 170 that purport to close the door on any state-enacted workarounds to the $10,000 limitation of § 164(b)(6) on a taxpayer's itemized deductions on Schedule A for the aggregate of state or local property taxes, income taxes, and sales taxes deducted in lieu of income taxes. (*See* REG-112176-18, Contributions in Exchange for State and Local Tax Credits, 83 F.R. 43563 (8/27/18).) Reg. § 1.170A-1(h)(3) generally requires taxpayers to reduce the amount of any federal income tax charitable contribution deduction by the amount of any corresponding state or local tax *credit* the taxpayer receives or expects to receive. The final regulations further provide that a corresponding state or local tax *deduction* normally will not reduce the taxpayer's federal deduction provided the state and local deduction does not exceed the taxpayer's federal deduction. To the extent the state and local charitable deduction exceeds the taxpayer's federal deduction, the taxpayer's federal deduction is reduced. Finally, the final regulations provide an exception whereby the taxpayer's federal charitable contribution deduction is not reduced if the corresponding state or local credit does not exceed 15 percent of the taxpayer's federal deduction. Pursuant to an amendment to Reg. § 1.642(c)-3(g), these same rules apply in determining the charitable contribution deductions of trusts and estates under § 642(c). Three examples illustrate the application of these rules:

Example 1. A, an individual, makes a payment of $1,000 to X, an entity listed in section 170(c). In exchange for the payment, A receives or expects to receive a state tax credit of 70% of the amount of A's payment to X. Under paragraph (h)(3)(i) of this section, A's charitable contribution deduction is reduced by $700 (70% × $1,000). This reduction occurs regardless of whether A may claim the state tax credit in that year. Thus, A's charitable contribution deduction for the $1,000 payment to X may not exceed $300.

Example 2. B, an individual, transfers a painting to Y, an entity listed in section 170(c). At the time of the transfer, the painting has a fair market value of $100,000. In exchange for the painting, B receives or expects to receive a state tax credit equal to 10% of the fair market value of the painting. Under paragraph (h)(3)(vi) of this section, B is not required to apply the general rule of paragraph (h)(3)(i) of this section because the amount of the tax credit received or expected to be received by B does not exceed 15% of the fair market value of the property transferred to Y. Accordingly, the amount of B's charitable contribution deduction for the transfer of the painting is not reduced under paragraph (h)(3)(i) of this section.

Example 3. C, an individual, makes a payment of $1,000 to Z, an entity listed in section 170(c). In exchange for the payment, under state M law, C is entitled to receive a state tax deduction equal to the amount paid by C to Z. Under paragraph (h)(3)(ii)(A) of this section, C is not required to reduce its charitable contribution deduction under section 170(a) on account of the state tax deduction.

Effective date. The final regulations are effective for charitable contributions made after August 27, 2018.

And another thing . . . . The final regulations do not discern between abusive "workarounds" enacted in response to § 164(b)(6) and legitimate state and local tax credit programs such as the

Georgia Rural Hospital Tax Credit that preceded the 2017 Tax Cuts and Jobs Act. The Georgia Rural Hospital Tax Credit program was enacted in 2017 to combat the closure of many rural hospitals in Georgia due to financial difficulties. Under the program, individuals and corporations making contributions to designated rural hospitals receive a 90 percent dollar-for-dollar tax credit against their Georgia state income tax liability. Is the Georgia Rural Hospital Tax Credit program adversely affected by proposed regulations under § 164(b)(6)? In our view, the answer is "yes" and a Georgia taxpayer's federal charitable contribution deduction for a donation to a Georgia rural hospital is reduced by 90 percent. Treasury and the IRS have adopted this view, which is reflected in the preamble to the final regulations:

> The regulations are based on longstanding federal tax law principles that apply equally to all taxpayers. To ensure fair and consistent treatment, the final regulations do not distinguish between taxpayers who make transfers to state and local tax credit programs enacted after the [Tax Cuts and Jobs] Act and those who make transfers to tax credit programs existing prior to the enactment of the Act. Neither the intent of the section 170(c) organization, nor the date of enactment of a particular state tax credit program, are relevant to the application of the *quid pro quo* principle.
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> We note, however, that it may be possible under state or local law for a taxpayer to waive any corresponding state or local tax credit and thereby claim a full charitable contribution for federal income tax purposes. *See* Rev. Rul. 67-246, 1967-2 C.B. 104. In the preamble to the final regulations, Treasury and the IRS noted that taxpayers might disclaim a credit by not applying for it if the credit calls for an application (or applying for a lesser amount) and requested comments as to how taxpayers may decline state or local tax credits in other situations. It is also possible, pursuant to a safe harbor established in Notice 2019-12, 2019-27 I.R.B. 57 (see below), for an individual who itemizes deductions to treat as a payment of state or local tax on Schedule A a payment made to a charitable organization for which the individual receives a state or local tax credit.

e. Down the rabbit hole we go. A safe harbor allows individuals who itemize to treat as payments of state or local tax any payments to § 170(c) charitable organizations that are disallowed as federal charitable contribution deductions because the individual will receive a state or local tax credit for the payment. Notice 2019-12, 2019-27 I.R.B. 57 (6/11/19). This notice announces that the Treasury Department and the IRS intend to publish a proposed regulation that will amend Reg. § 164-3 to provide a safe harbor for individuals who itemize deductions and make a payment to or for the use of an entity described in § 170(c) in return for a state or local tax credit. Until the proposed regulations are issued, taxpayers can rely on the safe harbor as set forth in the notice. Section 3 of the notice provides as follows:

> Under this safe harbor, an individual who itemizes deductions and who makes a payment to a section 170(c) entity in return for a state or local tax credit may treat as a payment of state or local tax for purposes of section 164 the portion of such payment for which a charitable contribution deduction under section 170 is or will be disallowed under final regulations. This treatment as a payment of state or local tax under section 164 is allowed in the taxable year in which the payment is made to the extent the resulting credit is applied, consistent with applicable state or local law, to offset the individual's state or local tax liability for such taxable year or the preceding taxable year. … To the extent the resulting credit is not applied to offset the individual's state or local tax liability for the taxable year of the payment or the preceding taxable year, any excess credit permitted to be carried forward may be treated as a payment of state or local tax under section 164 in the taxable year or years for which the carryover credit is applied, consistent with applicable state or local law, to offset the individual's state or local tax liability.

The safe harbor does not apply to a transfer of property and does not permit a taxpayer to treat the amount of any payment as deductible under more than one provision of the Code or regulations. The safe harbor applies to payments made after August 27, 2018. Three examples illustrate the application of these rules:

Example 1. In year 1, Taxpayer A makes a payment of $500 to an entity described in section 170(c). In return for the payment, A receives a dollar-for-dollar state income tax credit. Prior to application of the credit, A's state income tax liability for year 1 was $500 or more; A applies the $500 credit to A's year 1 state income tax liability. Under section 3 of this notice, A treats the $500 payment as a payment of state income tax in year 1 for purposes of section 164. To determine A's deduction amount, A must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).

Example 2. In year 1, Taxpayer B makes a payment of $7,000 to an entity described in section 170(c). In return for the payment, B receives a dollar-for-dollar state income tax credit, which under state law may be carried forward for three taxable years. Prior to application of the credit, B's state income tax liability for year 1 was $5,000; B applies $5,000 of the $7,000 credit to B's year 1 state income tax liability. Under section 3 of this notice, B treats $5,000 of the $7,000 payment as a payment of state income tax in year 1 for purposes of section 164. Prior to application of the remaining credit, B's state income tax liability for year 2 exceeds $2,000; B applies the excess credit of $2,000 to B's year 2 state income tax liability. For year 2, B treats the $2,000 as a payment of state income tax for purposes of section 164. To determine B's deduction amounts in years 1 and 2, B must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).

Example 3. In year 1, Taxpayer C makes a payment of $7,000 to an entity described in section 170(c). In return for the payment, C receives a local real property tax credit equal to 25 percent of the amount of this payment ($1,750). Prior to application of the credit, C's local real property tax liability in year 1 was $3,500; C applies the $1,750 credit to C's year 1 local real property tax liability. Under section 3 of this notice, for year 1, C treats $1,750 as a payment of local real property tax for purposes of section 164. To determine C's deduction amount, C must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).

f. Final regulations reflect previously issued guidance on payments to § 170(c) charitable organizations that result in state or local tax credits and provide additional guidance. TD 9907, Treatment of Payments to Charitable Entities in Return for Consideration, 85 F.R. 48467 (8/11/20). The Treasury Department and the IRS have finalized proposed regulations (REG-107431-19, Treatment of Payments to Charitable Entities in Return for Consideration, 84 F.R. 68833 (12/17/19)) that reflect previously issued guidance, including safe harbors, regarding payments to § 170(c) charitable organizations for business purposes or that result in state or local tax credits. The final regulations generally provide the following guidance.

Amendments to clarify the standard for payments to a charitable organization to qualify as a business expense. The final regulations amend Reg. § 1.162-15(a) to provide:

> A payment or transfer to or for the use of an entity described in section 170(c) that bears a direct relationship to the taxpayer's trade or business and that is made with a reasonable expectation of financial return commensurate with the amount of the payment or transfer may constitute an allowable deduction as a trade or business expense rather than a charitable contribution deduction under section 170.

See also Reg. § 1.170A-2(c)(5). This revision is intended to more clearly reflect current law regarding when payments from a business to a charitable organization qualify as a business expense (rather than as a charitable contribution). The regulations provide two examples, both of which involve businesses making payments to a § 170(c) charitable organization in exchange for advertising (e.g., a half-page advertisement in the program for a church concert) or to generate name recognition and goodwill (e.g., donating 1 percent of gross sales to charity each year). These amendments apply to amounts paid or property transferred after December 17, 2019. Nevertheless, taxpayers can choose to apply the amendments to payments or transfers made on or after January 1, 2018.

Safe harbors for payments by C corporations and specified pass-through entities to § 170(c) entities. The final regulations reflect amendments to Reg. § 1.162-15(a) to incorporate the safe harbors previously set forth in Rev. Proc. 2019-12, 2019-04 I.R.B. 401 (12/29/18). One safe harbor provides that C corporations that make payments to or for the use of § 170(c) charitable organizations and that receive or expect to receive corresponding tax credits against state or local taxes may treat such payments as meeting the requirements of an ordinary and necessary business expense for purposes of § 162(a). A similar safe harbor rule applies for entities other than C corporations, but only if the entity is a "specified passthrough entity." A specified passthrough entity for this purpose is one that meets four requirements. First, the entity must be a business entity other than a C corporation that is regarded for all federal income tax purposes as separate from its owners under Reg. § 301.7701-3 (i.e., it is not single-member LLC). Second, the entity must operate a trade or business within the meaning of § 162. Third, the entity must be subject to a state or local tax incurred in carrying on its trade or business that is imposed directly on the entity. Fourth, in return for a payment to a § 170(c) charitable organization, the entity receives or expects to receive a state or local tax credit that the entity applies or expects to apply to offset a state or local tax imposed upon the entity. The safe harbors for C corporations and specified passthrough entities apply only to payments of cash and cash equivalents. *See* Reg. § 1.162-15(a)(3)(iii). The safe harbor for specified passthrough entities does not apply if the credit received or expected to be received reduces a state or local income tax. *See* Reg. § 1.162-15(a)(3)(ii)(C). These amendments apply to amounts paid or property transferred after December 17, 2019. Nevertheless, taxpayers can choose to apply the amendments to payments or transfers made on or after January 1, 2018.

- *Example—C corporation receiving a state or local tax credit.* A, a C corporation engaged in a trade or business, makes a payment of $1,000 to a § 170(c) charitable organization. In return for the payment, A receives or expects to receive a dollar-for-dollar state tax credit to be applied to A's state corporate income tax liability. Under the revenue procedure, A may treat the $1,000 payment as meeting the requirements of an ordinary and necessary business expense under § 162. This example appears as example 1 in Reg. § 1.162-15(a)(3)(iv)(A).

- *Example—specified passthrough entity receiving a state or local tax credit.* S is an S corporation engaged in a trade or business and is owned by individuals C and D. S makes a payment of $1,000 to a § 170(c) charitable organization. In return for the payment, S receives or expects to receive a state tax credit equal to 80 percent of the amount of this payment ($800) to be applied to S's local real property tax liability incurred by S in carrying on its trade or business. Under applicable state and local law, the real property tax is imposed at the entity level (not the owner level). Under paragraph (a)(3)(ii) of [the regulation], S may treat $800 of the payment as meeting the requirements of an ordinary and necessary business expense under § 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by paragraph (a)(3)(ii) of [the regulation]. [In other words, the $200 could be a charitable contribution deductible under § 170 by the owners of the specified passthrough entity, or the $200 could be a business expense deductible at the entity level under § 162.] This example appears as example 4 in Reg. § 1.162-15(a)(3)(iv)(D).

A safe harbor for individuals who itemize deductions. The final regulations amend Reg. § 1.164-3(j) to incorporate the safe harbor previously provided in Notice 2019-12, 2019-27 I.R.B. 57 (6/11/19). Under this safe harbor, an individual who itemizes deductions and who makes a payment to a § 170(c) entity in return for a state or local tax credit may treat as a payment of state or local tax for purposes of § 164 the portion of the payment for which a charitable contribution deduction under § 170 is disallowed by Reg. § 1.170A-1(h)(3). This latter regulation generally disallows a taxpayer's federal charitable contribution deduction to the extent the taxpayer receives a state or local tax credit in exchange for a payment to a § 170(c) entity. For example, this safe harbor would permit an individual who makes a $1,000 payment to a § 170(c) entity and who, in exchange, receives a $700 state or local tax credit to treat the $700 that is disallowed as a federal charitable contribution deduction as a payment of state or local tax that is deductible on Schedule A, subject to the $10,000 limit of § 164(b)(6). These amendments apply to payments made on or after June 11, 2019 (the date the IRS issued Notice 2019-12), but individuals can choose to apply the amendments to Reg. § 1.164-3(j) to payments made after August 27, 2018.

Amendments to clarify the effect of benefits provided to a donor that are not provided by the § 170(c) entity. The final regulations propose amending Reg. § 1.170A-1(h)(4)(i) to provide:

> A taxpayer receives goods or services in consideration for a taxpayer's payment or transfer to an entity described in section 170(c) if, at the time the taxpayer makes the payment to such entity, the taxpayer receives or expects to receive goods or services from that entity or any other party in return.

This amendment is intended to clarify that the *quid pro quo* principle, under which a taxpayer's charitable contribution deduction is disallowed to the extent the taxpayer receives goods or services in return, applies regardless of whether the goods or services are provided by the § 170(c) entity receiving the contribution. The preamble to the proposed regulations discussed judicial decisions that have adopted this approach, such as *Singer v. United States*, 449 F.2d 413(Ct. Cl. 1971) and *Wendell Falls Development, LLC v. Commissioner*, T.C. Memo. 2018-45. The IRS reached a similar result in example 11 of Rev. Rul. 67-246, 1967-2 C.B. 104, in which a taxpayer who made a $100 payment to a specific charity and, in return, received a transistor radio worth $15 from a local store could take a charitable contribution deduction of only $85. The final regulations also amend Reg. § 1.170A-1(h)(4)(ii) to define "goods or services" for this purpose as "cash, property, services, benefits, and privileges." These amendments apply to amounts paid or property transferred after December 17, 2019.

- As a result, although the payment or transfer to a § 170(c) organization accompanied by the receipt of goods or services from a third party may not qualify for the charitable contribution deduction (and likewise will not count against the charitable contribution deduction percentage limits of § 170(b)(1) or (2)), the payment or transfer may be deductible as an ordinary and necessary business expense under § 162. This is welcome news for so-called "social enterprise" businesses that "donate" all or a large portion of their profits to charity.

2. Dependency defined! Treasury releases proposed regulations clarifying the definition of a "qualifying relative" REG-118997-19, Dependent Defined; Notice of Proposed Rulemaking and Partial Withdrawal of Notice of Proposed Rulemaking, 85 F.R. 35233 (6/9/20). Treasury and the IRS have issued newly proposed regulations revising old proposed regulations issued in January 2017 to clarify the definition of who is a "qualifying relative" for tax years 2018 through 2025. In general, taxpayers may claim an exemption deduction for the taxpayer, his or her spouse, and for any dependents ("qualifying child" or a "qualifying relative"). §§ 151; 152(a). Importantly, to be a qualifying relative, the individual's gross income must be less than the exemption amount in § 151(d). Before the 2017 old proposed regulations and the enactment of the Tax Cuts and Jobs Act (TCJA), § 151(d) provided for an inflation adjusted exemption for 2018 of $4,150. However, the TCJA added § 151(d)(5) providing that, for the years 2018-2025, the exemption amount is zero. Essentially, the TCJA, suspended the personal and dependency exemption deductions. However, the reduction of the exemption amount to zero should not and does not impact whether a taxpayer is allowed or entitled to a deduction for purposes of any other provision of the Code. § 151(d)(5)(B). Specifically, the Conference Report that accompanied the TCJA (H.R. Rep. No. 115-466, at 202-204 (2017)) clarifies that the reduction of the personal exemption to zero "should not alter the operation of those provisions of the Code which refer to a taxpayer allowed a deduction . . . under section 151" including the child tax credit in § 24(a). Conference Report at 203 n.16. The TCJA also amended § 24 to allow for a $500 credit for qualifying relatives as defined in § 152(d). See § 24(h)(4)(A). The $500 credit for qualifying relatives also applies for the years 2018 through 2025. Thus, the reduction of the exemption amount to zero during these years is not taken into account in determining whether an individual meets the definition of qualifying relative. Notice 2018-70, 2018-38 I.R.B. 441. Newly proposed Reg. § 1.152-3(c)(3)(i) provides in part:

> For tax year 2018, the exemption amount under section 152 (d)(1)(B) is $4,150. For tax years 2019 through 2025, the exemption amount, as adjusted for inflation, is set forth in annual guidance published in the Internal Revenue Bulletin. See § 601.601(d)(2) of this chapter…

As such, Prop. Reg. § 1.152-3(c)(3), defining "qualifying relative," provides for an inflation adjusted exemption amount for 2019-2025. Treasury argues that this language in the newly proposed regulation is supported by the wording of § 152(d)(1)(B). To be included in the definition of a "qualifying relative" under the wording of § 152(d)(1)(B), an individual must have gross income that is "less than the exemption amount." If the exemption amount were zero, such an individual's gross income would have to be less than zero. Such an interpretation would make no sense because, under such circumstances, no individual would meet the definition of a qualifying relative. Treasury further supports this interpretation by concluding that Congress could not have intended to make such a significant change in such an indirect manner. For the same reasons, the newly proposed regulations provide for similar amendments to Prop. Reg. § 1.24-1, Partial credit allowed for certain other dependents, and subsection (d) of Prop. Reg. 1.152-3(d), relating to alimony and separate maintenance payments as well.

E. Divorce Tax Issues

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VI. CORPORATIONS

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B. Distributions and Redemptions

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VII. PARTNERSHIPS

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1. Relief for not reporting negative tax capital accounts. Notice 2019-20, 2019-14 I.R.B. 927 (3/7/19). The updated 2018 Instructions for Form 1065 and accompanying Schedule K-1 now require a partnership that does not report tax basis capital accounts to its partners to report, on line 20 of Schedule K-1 (Form 1065) using code AH, the amount of a partner's tax basis capital both at the beginning of the year and at the end of the year if either amount is negative. Aware that some taxpayers and their advisors may not have been prepared to comply with this new requirement for 2018 returns, the IRS, in Notice 2019-20, has provided limited relief. Specifically, the IRS will waive penalties (1) under § 6722 for failure to furnish a partner a Schedule K-1 (Form 1065) and under § 6698 for failure to file a Schedule K-1 (Form 1065) with a partnership return, (2) under § 6038 for failure to furnish a Schedule K-1 (Form 8865), and (3) under any other section of the Code for failure to file or furnish a Schedule K-1 or any other form or statement, for any penalty that arises solely as a result of failing to include negative tax basis capital account information provided the following conditions are met:

1. The Schedule K-1 or other applicable form or statement is timely filed, including extensions, with the IRS; is timely furnished to the appropriate partner, if applicable; and contains all other required information.
2. The person or partnership required to file the Schedule K-1 or other applicable form or statement files with the IRS, no later than one year after the original, unextended due date of the form to which the Schedule K-1 or other applicable form or statement must be attached, a schedule setting forth, for each partner for which negative tax basis capital account information is required: (a) the partnership's name and Employer Identification Number, if any, and Reference ID Number, if any; (b) the partner's name, address, and taxpayer identification number; and (c) the amount of the partner's tax basis capital account at the beginning and end of the tax year at issue.

The above-described supplemental schedule should be captioned "Filed Under Notice 2019-20" in accordance with instructions and additional guidance posted by the IRS on www.IRS.gov. The due date for this supplemental schedule is determined without consideration of any extensions, automatic or otherwise, that may apply to the due date for the form itself. Furthermore, the schedule should be sent to the address listed in the Notice, and the penalty relief applies only for taxable years beginning after December 31, 2017, but before January 1, 2019.

a. The IRS has issued FAQ guidance on negative tax basis capital account reporting. The IRS has issued guidance on the requirement to report negative tax basis capital account information in the form of frequently asked questions (FAQs) on its website. The FAQs are available at ***https://www.irs.gov/businesses/partnerships/form-1065-frequently-asked-questions***.

Definition and calculation of tax basis capital accounts. In the FAQs, the IRS explains that "[a] partner's tax basis capital account (sometimes referred to simply as 'tax capital') represents its equity as calculated using tax principles, not based on GAAP, § 704(b), or other principles." The FAQs provide guidance on the calculation of a partner's tax basis capital account. A partner's tax basis capital account is *increased by the amount of money and the adjusted basis of any property contributed* by the partner to the partnership (less any liabilities assumed by the partnership or to which the property is subject) and is *decreased by the amount of money and the adjusted basis of any property distributed by the partnership to the partner* (less any liabilities assumed by the partner or to which the property is subject). The partner's tax basis capital account is increased by certain items, such as the partner's distributive share of partnership income and gain, and is decreased by certain items, such as the partner's distributive share of partnership losses and deductions. The FAQs make clear that a partner's tax basis capital account is not the same as a partner's basis in the partnership interest (outside basis) because outside basis includes the partner's share of partnership liabilities, whereas a partner's tax basis capital account does not.

Effect of § 754 Elections and Revaluations of Partnership Property. If a partnership has a § 754 election in effect, then it increases or decreases the adjusted basis of partnership property pursuant to § 743(b) when there is a transfer of a partnership interest or pursuant to § 734(b) when there is a distribution by the partnership. These adjustments can also be triggered when the partnership does not have a § 754 election in effect but has a substantial built-in loss and a transfer of a partnership interest occurs (§ 743(b) basis adjustment) or experiences a substantial basis reduction in connection with a distribution (§ 734(b) basis adjustment). The FAQs clarify that a partner's tax basis capital account *is increased or decreased by a partner's share of basis adjustments under § 743(b) and § 734(b).* In contrast, according to the FAQs, *revaluations of partnership property* pursuant to § 704 (such as upon the entry of a new partner) *do not affect the tax basis of partnership property or a partner's tax basis capital account*.

Examples. The FAQs provide the following examples of the calculation of a partner's tax basis capital account:

> *Example 1:* A contributes \$100 in cash and B contributes unencumbered, nondepreciable property with a fair market value (FMV) of \$100 and an adjusted tax basis of \$30 to newly formed Partnership AB. A's initial tax basis capital account is \$100 and B's initial tax basis capital account is \$30.

Example 2: The facts are the same as in Example 1, except B contributes nondepreciable property with a FMV of $100, an adjusted tax basis of $30, and subject to a liability of $20. B's initial tax basis capital account is $10 ($30 adjusted tax basis of property contributed, less the $20 liability to which the property was subject).

Example 3: The facts are the same as in Example 1, except in Year 1, the partnership earns $100 of taxable income and $50 of tax-exempt income. A and B are each allocated $50 of the taxable income and $25 of the tax-exempt income by the partnership. At the end of Year 1, A's tax basis capital account is increased by $75, to $175, and B's tax basis capital account is increased by $75, to $105.

Example 4: The facts are the same as in Example 3. Additionally, in Year 2, the partnership has $30 of taxable loss and $20 of expenditures which are not deductible in computing partnership taxable income and which are not capital expenditures. A and B are each allocated $15 of the taxable loss and $10 of the expenditures which are not deductible in computing partnership taxable income and which are not capital expenditures. At the end of Year 2, A's tax basis capital account is decreased by $25, to $150, and B's tax basis capital account is decreased by $25, to $80.

Example 5: On January 1, 2019, A and B each contribute $100 in cash to a newly formed partnership. On the same day, the partnership borrows $800 and purchases Asset X, qualified property for purposes of §168(k), for $1,000. Assume that the partnership properly allocates the $800 liability equally to A and B under §752. Immediately after the partnership acquires Asset X, both A and B have tax basis capital accounts of $100 and outside bases of $500 ($100 cash contributed, plus $400 share of partnership liabilities under §752). In 2019, the partnership recognizes $1,000 of tax depreciation under §168(k) with respect to Asset X; the partnership allocates $500 of the tax depreciation to A and $500 of the tax depreciation to B. On December 31, 2019, A and B both have tax basis capital accounts of negative $400 ($100 cash contributed, less $500 share of tax depreciation) and outside bases of zero ($100 cash contributed, plus $400 share of partnership liabilities under § 752, and less $500 of share tax depreciation).

Tax Basis Capital Account of a Partner Who Acquires the Partnership Interest from Another Partner. A partner who acquires a partnership interest from another partner, such as by purchase or in a non-recognition transaction, has a tax basis capital account immediately after the transfer equal to the transferring partner's tax basis capital account immediately before the transfer with respect to the portion of the interest transferred. However, any § 743(b) basis adjustment the transferring partner may have is not transferred to the acquiring partner. Instead, if the partnership has a §754 election in effect, the tax basis capital account of the acquiring partner is increased or decreased by the positive or negative adjustment to the tax basis of partnership property under §743(b) as a result of the transfer.

Safe Harbor Method for Determining a Partner's Tax Basis Capital Account. The FAQs provide a safe harbor method for determining a partner's tax basis capital account. Under this method, "[p]artnerships may calculate a partner's tax basis capital account by subtracting the partner's share of partnership liabilities under § 752 from the partner's outside basis (safe harbor approach). If a partnership elects to use the safe harbor approach, the partnership must report the negative tax basis capital account information as equal to the excess, if any, of the partner's share of partnership liabilities under § 752 over the partner's outside basis."

Certain partnerships are exempt from reporting negative tax basis capital accounts. Partnerships that satisfy four conditions (those provided in question 4 on Schedule B to Form 1065) do not have to comply with the requirement to report negative tax basis capital account information. This is because a partnership that satisfies these conditions is not required to complete item L on Schedule K-1. The four conditions are: **(1)** the partnership's total receipts for the tax year were less than $250,000; **(2)** the partnership's total assets at the end of the tax year were less than $1 million; **(3)** Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return; and **(4)** the partnership is not filing and is not required to file Schedule M-3.

b. The IRS has issued a draft of revised Form 1065 and Schedule K-1 for 2019. IR-2019-160 (9/30/19). The IRS has issued a draft of the partnership tax return, Form 1065, and accompanying Schedule K-1 for 2019. The IRS has also released draft instructions for the 2019 Form 1065 and draft instructions for the 2019 Schedule K-1. Compared to the 2018 versions, the 2019 versions reflect several significant changes that likely will require a substantial amount of time in many cases on the part of those preparing the return to ensure compliance. Among the significant changes are the following:

- *Reporting of tax basis capital accounts for each partner on Schedule K-1*. Previous versions of Schedule K-1 gave partnerships the option to report a partner's capital accounts on a tax basis, in accordance with GAAP, as § 704(b) book capital accounts, or on some "other" basis. Tax basis capital accounts were required beginning in 2018 only if a partner's tax capital account at the beginning or end of the year was negative. The 2019 draft Schedule K-1 requires partnerships to report each partner's capital account on a tax basis regardless of whether the account is negative. For partnerships that have not historically reported tax basis capital accounts, this requirement would appear to involve recalculating tax capital accounts in prior years and rolling them forward.
- *Reporting a partner's share of net unrecognized § 704(c) gain or loss on Schedule K-1.* Previous versions of Schedule K-1 required reporting whether a partner had contributed property with a built-in gain or built-in loss in the year of contribution. The 2019 draft Schedule K-1 still requires partnerships to report whether a partner contributed property with a built-in gain or loss, but adds new item N in Part II, which requires reporting the "Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)." This means that a partnership must report on an annual basis any unrecognized gain or loss that would be allocated to the partner under § 704(c) (if the partnership were to sell its assets) as a result of either the partner contributing property with a fair market value that differs from its adjusted basis or the revaluation of partnership property (such as a revaluation occurring upon the admission of a new partner).
- *Separation of guaranteed payments for capital and services.* Previous versions of Schedule K-1 required reporting a single category of guaranteed payments to a partner. The 2019 draft Schedule K-1 refines this category in item 4 of Part III and requires separate reporting of guaranteed payments for services, guaranteed payments for capital, and the total of these two categories.
- *Reporting on Schedule K-1 more than one activity for purposes of the at risk and passive activity loss rules.* Items 21 and 22 have been added to Part III of Schedule K-1 to require the partnership to check a box if the partnership has more than one activity for purposes of the at-risk or passive activity loss rules. The 2019 draft instructions for Form 1065 indicate that the partnership also must provide an attached statement for each activity with detailed information for each activity to allow the partner to apply correctly the at-risk and passive activity loss rules.
- *Section 199A deduction moved to supplemental statement.* The 2018 version of Schedule K-1 required reporting information relevant to the partner's § 199A deduction in item 20 of Part III with specific codes. The draft 2019 instructions for Form 1065 provide that, for partners receiving information relevant to their § 199A deduction, only code Z should be used in box 20 along with an asterisk and STMT to indicate that the information appears on an attached statement. According to the instructions, among other items, the statement must include the partner's distributive share of: (1) qualified items of income, gain, deduction, and loss; (2) W-2 wages; (3) unadjusted basis immediately after acquisition of qualified property; (4) qualified publicly traded partnership items; and (5) § 199A dividends (qualified REIT dividends). The statement also must report whether any of the partnership's trades or businesses are specified service trades or businesses and identify any trades or businesses that are aggregated.
- *Disregarded entity as a new category of partner on Schedule K-1.* Previous versions of Schedule K-1 required the partnership to indicate whether the partner was domestic or foreign. The 2019 draft Schedule K-1 adds a new category in item H of Part II in which the partnership

must indicate whether the partner is a disregarded entity and, if so, the partner's taxpayer identification number and type of entity.

c. The IRS has postponed the requirements to use tax basis capital accounts for Schedule K-1 and to report detailed information for purposes of the at-risk rules and has clarified certain other reporting requirements. Notice 2019-66, 2019-52 I.R.B. 1509 (12/9/19). In response to comments expressing concern that those required to file Form 1065 and Schedule K-1 might be unable to comply in a timely manner with the requirement to report capital accounts on a tax basis for 2019, the Treasury Department and the IRS have deferred this requirement, which will now apply to partnership tax years beginning on and after January 1, 2020. According to the notice:

> This means that partnerships and other persons may continue to report partner capital accounts on Forms 1065, Schedule K-1, Item L, or 8865, Schedule K-1, Item F, using any method available in 2018 (tax basis, Section 704(b), GAAP, or any other method) for 2019. These partnerships and other persons must include a statement identifying the method upon which a partner's capital account is reported.

The requirement to report capital accounts for 2019 using any method available in 2018 includes the requirement that partnerships that do not report tax basis capital accounts to partners must report, on line 20 of Schedule K-1 (Form 1065) using code AH, the amount of a partner's tax basis capital both at the beginning of the year and at the end of the year if either amount is negative.

The draft 2019 Schedule K-1 included Items 21 and 22 in Part III to require the partnership to check a box if the partnership has more than one activity for purposes of the at-risk or passive activity loss rules. The 2019 draft instructions for Form 1065 also required a partnership to provide an attached statement for each activity with detailed information for each activity to allow the partner to apply correctly the at-risk and passive activity loss rules. In response to comments expressing concern that those required to file Form 1065 and Schedule K-1 might be unable to comply in a timely manner with the requirement to provide this detailed information in an attached statement, the notice defers this requirement. This requirement now will apply to partnership tax years beginning on and after January 1, 2020. The notice leaves in place for 2019 the requirement that a box be checked in Items 21 and 22 in Part III of Schedule K-1 if the partnership has more than one activity for purposes of the at-risk or passive activity loss rules.

The notice leaves in place for 2019 the requirement that a partnership must report on an annual basis a partner's share of "net unrecognized Section 704(c) gain or loss." The draft 2019 instructions for Schedule K-1, however, had not defined the term "net unrecognized Section 704(c) gain or loss." The notice defines this term as "the partner's share of the net (net means aggregate or sum) of all unrecognized gains or losses under section 704(c) of the Code (Section 704(c)) in partnership property, including Section 704(c) gains and losses arising from revaluations of partnership property." This definition applies solely for purposes of completing 2019 forms. The notice clarifies that publicly traded partnerships need not report net unrecognized § 704(c) gain for 2019 and future years until further notice. The notice also indicates that commenters had requested additional guidance on § 704(c) computations, especially on issues such as those addressed in Notice 2009-70, 2009-34 I.R.B. 255, which solicited comments on the rules relating to the creation and maintenance of multiple layers of forward and reverse section § 704(c) gain and loss to partnerships and tiered partnerships. Notice 2019-66 provides that, "[f]or purposes of reporting for 2019, partnerships and other persons should generally resolve these issues in a reasonable manner, consistent with prior years' practice for purposes of applying Section 704(c) to partners."

The notice provides that taxpayers who follow the provisions of the notice will not be subject to any penalty for reporting in accordance with the guidance it provides.

d. The Service has proposed two exclusive methods for satisfying the requirement to report tax basis capital accounts for partnership taxable years ending on or after December 31, 2020, and has asked for comments. Notice 2020-43, 2020-27 I.R.B. 1 (6/5/20). In this notice, the IRS has proposed a requirement that partnerships use only one of two exclusive methods for reporting a partner's tax capital account that would apply to partnership taxable years that end on or after December 31, 2020. Pursuant to the proposed requirement, partnerships would no longer be permitted to report partner capital accounts using any other method, including reporting capital accounts in accordance with GAAP or as § 704(b) book capital accounts. The notice indicates that comments received in response to the notice "will help inform the development of the instructions to be included in Form 1065 ... for taxable year 2020."

Background. According to the notice, commenters have indicated that they determine tax basis capital accounts using what the notice refers to as a "Transactional Approach." It appears that this approach is analogous to the method for determining a partner's book capital account prescribed in the regulations regarding the substantial economic effect requirement of § 704(b), except that the adjusted basis of property is used instead of the property's fair market value. Under this Transactional Appproach, a partner's tax capital account is (1) increased by the amount of money and the adjusted basis of property contributed by a partner (less any liabilities assumed by the partnership or to which the property is subject) and by allocations to the partner of partnership income or gain, and (2) decreased by the amount of money and the adjusted basis of property distributed to the partner (less any liabilities assumed by the partner or to which the distributed property is subject) and by allocations to the partner of partnership loss or deduction. The notice indicates that Treasury and the IRS understand that partnerships using the Transactional Approach may not have been adjusting partner tax capital accounts in the same way under similar fact patterns. Further, issuing detailed guidance to promote consistent application of the Transactional Approach, according to some commenters, would be a major project that would consume significant IRS resources. Accordingly, the notice rejects a Transactional Approach to determining tax capital accounts and indicates that tax capital accounts determined in this manner will not satisfy the requirement to report partner tax capital accounts. Instead, the notice prescribes two alternative proposed methods for determining a partner's tax capital account: (1) the "Modified Outside Basis Method," and (2) the "Modified Previously Taxed Capital Method." These methods are discussed below.

Modified Outside Basis Method. The notice indicates that a partnership using this method to determine a partner's tax capital account must determine, or be provided by the partner, the partner's adjusted basis in the partnership interest (determined under the principles and provisions of subchapter K, including §§ 705, 722, 733, and 742) and subtract from it the partner's share of partnership liabilities under § 752. (This method was described as a safe harbor approach in the FAQs discussed above, which appear on the IRS website.) If the partnership is using this method, a partner must notify the partnership in writing of changes to the partner's basis in the partnership during the year other than those attributable to contributions by the partner, distributions to the partner, and allocations to the partner of income, gain, loss or deduction that are reflected on the partnership's Schedule K-1. An example of a situation in which notification to the partnership would be required is if a person purchases a partnership interest. A partnership using the Modified Outside Basis Method is entitled to rely on information provided by partners regarding their basis in partnership interests unless the partnership has knowledge of facts indicating that the information is clearly erroneous.

Modified Previously Taxed Capital Method. This method is a modified version of the method prescribed in Reg. § 1.743-1(d). The method prescribed in this regulation is used in determining the adjustments to the basis of partnership property under § 743(b) when a person purchases a partnership interest and the partnership has in effect a § 754 election. One adjustment is to increase the adjusted basis of partnership property by the excess of the purchasing partner's basis in the partnership interest over the partner's *proportionate share of the adjusted basis of partnership property*. A partner's proportionate share of the adjusted basis of partnership property is the purchasing partner's *interest as a partner in the partnership's previously taxed capital*, plus his or her share of partnership liabilities. In essence, the method prescribed in Reg. § 1.743-1(d) determines the partner's interest in the partnership's previously taxed capital (i.e., tax capital account) by first determining the partner's share of total capital and then backing out the portion that has not yet been taxed. Specifically, Reg. § 1.743-1(d) provides that a partner's share of previously taxed capital is determined by performing a hypothetical disposition by the partnership of all of its assets in a fully taxable transaction for cash equal to the *fair market value of the assets* and ascertaining:

1. The amount of cash the partner would receive on a liquidation following the hypothetical disposition of assets, increased by
2. The amount of tax loss that would be allocated to the partner from the hypothetical disposition of assets, and decreased by
3. The amount of tax gain that would be allocated to the partner from the hypothetical disposition of assets.

The notice modifies this method in two ways. *First*, it modifies the hypothetical disposition of assets to permit partnerships to use the fair market of assets if the fair market value is readily available or, alternatively, the bases of assets determined under § 704(b) (i.e., § 704(b) book basis), GAAP, "or the basis set forth in the partnership agreement for purposes of determining what each partner would receive if the partnership were to liquidate, as determined by partnership management." *Second*, for purposes of the second and third parts of the method set forth (allocation of tax loss and gain), the notice provides that all partnership liabilities are treated as nonrecourse "to avoid the burden of having to characterize the underlying debt and to simplify the computation." Partnerships that use the Modified Previously Taxed Capital Method will be required, for each year that the method is used, to attach to the partnership tax return a statement indicating that the Modified Previously Taxed Capital Method is used and the method used to determine the partnership's net liquidity value (such as fair market value, § 704(b) book basis, or GAAP).

Consistency and Change of Methods. The notice indicates that, whichever of the two methods the partnership uses, it must use the same method with respect to all partners. The first year for which the requirement to use one of these two methods to determine tax capital accounts will apply is 2020. For taxable years after 2020, the partnership can change methods by attaching a disclosure to each Schedule K-1 that describes the change (if any) to the amount attributable to each partner's beginning and end-of-year balances and the reason for the change.

Request for Comments. The IRS has requested comments, due by August 4, 2020, on the following five topics:

1. Whether the two proposed exclusive methods described above for determining tax capital accounts should be modified or adopted;
2. Whether, in connection with the hypothetical disposition of assets required as part of the Modified Previously Taxed Capital Method, an ordering rule should apply to the value used in the hypothetical disposition, e.g., use of fair market value might be required if readily available, and if it is not readily available, then § 704(b) book basis might be required unless the partnership does not maintain book capital accounts in accordance with § 704(b), in which case GAAP would be required;
3. How, if at all, the requirement to report tax capital accounts should be modified to apply to publicly traded partnerships;
4. Whether a Transactional Approach to determining tax capital accounts should be permitted and what additional guidance would be necessary to permit this approach; and
5. Whether (and in what circumstances) limitations should be imposed on partnerships to change from one method of determining tax capital accounts to another, including how partnerships would comply with such limitations in the case of the merger of partnerships using different methods.

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

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

1. Tax Court retains jurisdiction in a § 7345 passport revocation case to review IRS's certification of taxpayer's "seriously delinquent" tax liability but finds case is moot. Ruesch v. Commissioner, 154 T.C. No. 13 (6/25/20). Section 7345, which addresses the revocation or denial of passports for serioulsy delinquent tax debts, was enacted in 2015 as section 32101(a) of the Fixing America's Surface Transportation Act, Pub. L. 114-94 (Dec. 4, 2015). It provides that, if the IRS certifies that an individual has a "seriously delinquent tax debt," the Secretary of the Treasury must notify the Secretary of State "for action with respect to denial, revocation, or limitation of a passport." § 7345(a). In general, a seriously delinquent tax debt is an unpaid tax liability in excess of $50,000 for which a lien or levy has been imposed. § 7345(b)(1). A taxpayer who seeks to challenge such certification may petition the Tax Court to determine if it was made erroneously. § 7345(e)(1). If the Tax Court finds the certification was either made in error or that the IRS has since reversed its certification, the court may then notify the State Department that the revocation of the taxpayer's passport should be cancelled. § 7345(c). This is a case of first impression in which the Tax Court interprets the requirements of § 7345. The Tax Court (Judge Lauber) held that, while the Tax Court had jurisdiction to review Ms. Ruesch's challenge to the IRS's certification of her tax liabilities as being a "seriously delinquent tax debt," the controversy was moot because the IRS had reversed its certification as being erroneous. Further, the IRS had properly notified the Secretary of State of its reversal. The IRS had assessed $160,000 in penalties for failing to file proper information returns for a period of years. *See* § 6038. Thereafter, the IRS sent a final notice of intent to levy and Ms. Ruesch properly appealed the penalty amounts with the IRS's Collection Appeals Program (CAP). In a series of errors, the IRS mistakenly misclassified the CAP appeal as a Collection Due Process (CDP) hearing. Committing yet further errors, the IRS failed to properly record Ms. Ruesch's later request for a CDP hearing and never offered Ms. Ruesch her CDP hearing. The IRS then certified Ms. Ruesch's liability to the Secretary of State as a "seriously delinquent tax debt" under § 7345(b). Discovering their many errors as well as the oversight of Ms. Ruesch's timely requested a CDP hearing, the IRS determined her tax debt was not "seriously delinquent" and reversed the certification. Because, under § 7345, the Tax Court's jurisdiction in passport revocation cases is limited to reviewing the IRS's certification of the taxpayer's liabilities as "seriously delinquent," the only relief the Tax Court may grant is to issue an order to the IRS to notify the Secretary of State that the IRS's certification was in error. Since the IRS had already notified the Secretary of State of the error, the Tax Court could not offer any additional relief. Judge Lauber, therefore, found the controversy was not ripe to be heard and the issues were moot.

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

A. Enacted