# 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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# I. ACCOUNTING

# II. BUSINESS INCOME AND DEDUCTIONS

## A. Income

## B. Deductible Expenses versus Capitalization

## C. Reasonable Compensation

## D. Miscellaneous Deductions

1. **Seinfeld warned us: no double-dipping (with your PPP money)! Or, on second thought, maybe you can!** Notice 2020-32, 2020-21 I.R.B. 1 (5/1/20). Section 1102 of the CARES Act, in tandem with § 7(a)(36) of the Small Business Act (15 U.S.C. § 636(a)(36)), establishes the much-touted Paycheck Protection Program ("PPP"). The PPP was created to combat the devastating economic impact of the coronavirus pandemic. Generally speaking, the PPP facilitates bank-originated,

federally-backed loans ("covered loans") to fund payroll and certain other trade or business expenses ("covered expenses") paid by taxpayers during an eight-week period following the loan's origination date. Moreover, § 1106(b) of the CARES Act allows taxpayers to apply for debt forgiveness with respect to all or a portion of a covered loan used to pay covered expenses. Section 1106(i) of the CARES Act further provides that any such forgiven debt meeting specified requirements may be excluded from gross income by taxpayer-borrowers.

*Background.* The CARES Act does not address whether covered expenses funded by a forgiven covered loan are deductible for federal income tax purposes. Normally, of course, covered expenses would be deductible by a taxpayer under either Code § 162, § 163, or similar provisions; however, a long-standing provision of the Code, § 265(a)(1), disallows deductions for expenses allocable to one or more classes of income "wholly exempt" from federal income tax. Put differently, § 265(a)(1) generally prohibits taxpayers from double-dipping: taking deductions for expenses attributable to tax-exempt income. Section 265 most often has been applied to disallow deductions for expenses paid to seek or obtain tax-exempt income. (For example, a taxpayer claiming nontaxable social security disability benefits pays legal fees to pursue the claim. The legal fees are not deductible under Code § 265(a)(1). *See* Rev. Rul. 87-102, 1987-2 C.B. 78.) Covered expenses, on the other hand, presumably would have been incurred by taxpayers (at least in part) regardless of the PPP. The question arises, therefore, whether covered expense deductions are disallowed by Code § 265 when all or a portion of a PPP covered loan *subsequently* is forgiven.

*Notice 2020-32*. The notice sets forth the IRS's position that covered expenses funded by the portion of a PPP covered loan subsequently forgiven are not deductible pursuant to § 265. The IRS reasons that regulations under § 265 define the term "class of exempt income" as any class of income (whether or not any amount of income of such class is received or accrued) that is either wholly excluded from gross income for federal income tax purposes or wholly exempt from federal income taxes. *See* Reg. § 1.265-1(b)(1). Thus, because the forgiven portion of a covered loan is nontaxable (i.e., "wholly exempt") and is tied to the taxpayer's expenditure of the loan proceeds for covered expenses, § 265 disallows a deduction for those expenses. The IRS also cites several cases in support of its position. *See Manocchio v. Commissioner*, 78 T.C. 989 (1982) (taxpayer-pilot's flight-training expenses funded with a nontaxable Veteran's Administration allowance not deductible pursuant to § 265(a)(1)), *aff'd on other grounds*, 710 F.2d 1400 (9th Cir. 1983); *Banks v. Commissioner*, 17 T.C. 1386 (1952) (deduction for business-related educational expenses disallowed under § 265(a)(1) when paid by the Veterans' Administration and not taxable to taxpayer); *Heffelfinger v. Commissioner*, 5 T.C. 985 (1945) (Canadian income taxes on income exempt from U.S. tax are not deductible in computing U.S. taxable income pursuant to § 265(a)(1)'s statutory predecessor). As if to convince itself, though, the IRS also cites as support—but without analysis—several arguably inapposite cases that do not rely upon § 265(a)(1). Instead, these cases hold that expenditures reimbursed from or directly tied to nontaxable funds are not deductible. *See, e.g., Burnett v. Commissioner*, 356 F.2d 755, 759-60 (5th Cir. 1966) (living expenses advanced by personal injury attorney to clients pending outcome of lawsuit not deductible because the expenses will be reimbursed from the lawsuit proceeds); *Wolfers v. Commissioner*, 69 T.C. 975 (1978) (taxpayer cannot deduct relocation costs funded with nontaxable proceeds from Federal Reserve Bank); *Charles Baloian Co. v. Commissioner*, 68 T.C. 620 (1977) (similar).

*A possible legislative solution?* The authors doubt that Notice 2020-32 is the last word on the tax treatment of PPP covered loans and covered expenses. Apparently, many practitioners and at least a few members of Congress believe that the IRS's position in Notice 2020-32 contravenes congressional intent. *See* Chamseddine and Yauch, *Neal Plans PPP Fix to Provide Expenses Deduction*, 2020 TNTF 86-5 (5/4/20). Treasury Secretary Mnuchin, though, has defended the IRS's position. *See* Chamseddine, "Tax 101": Mnuchin Defends Nondeductibility of PPP Expenses, 2020 TNTF 87-2 (5/5/20). Furthermore, what happens to capitalized covered expenses? Are taxpayers forced to reduce basis when a portion of a covered loan is forgiven? What about outside basis adjustments for S corporations and partnerships that have paid covered expenses with the proceeds of a subsequently forgiven covered loan? Remember *Gitlitz v. Commissioner*, 531 U.S. 206 (2001) (excludable cancellation of indebtedness increases S corporation shareholder's outside basis allowing use of previously suspended losses) followed by enactment of § 108(d)(7)(A) (legislatively overruling *Gitlitz*)?

*A broader perspective.* Perhaps the unstated but no less unsettling aspect of Notice 2020-32 is that the Notice fails to address adequately the inconsistent application of § 265 by the IRS and Treasury. It is well established that § 265(a)(1) disallows so-called "forward looking" deductions allocable to "wholly exempt" income (i.e., expenses paid to earn or obtain exempt income). For instance, as mentioned above § 265(a)(1) disallows a deduction for legal fees paid to pursue a nontaxable social security disability award. *See* Rev. Rul. 87-102, 1987-2 C.B. 78. Less established, however, is whether § 265 disallows so-called "backward looking" deductions (i.e., expenses funded with tax-exempt income but not paid to obtain such tax-exempt income). *Cf.* Rev. Rul. 75-232, 1975-1 C.B. 94 (taxpayer can exclude from income under § 104(a)(2) a settlement, including the portion allocated to future medical expenses, but cannot deduct that portion of the future medical expenses when incurred). For example, a taxpayer might receive an excludable bequest of artwork but nonetheless is allowed a charitable contribution deduction upon donating the artwork to a tax-exempt museum. For a thorough analysis, see Dodge, *Disallowing Deductions Paid with Excluded Income*, 32 Va. Tax Review 749 (2013).

**a. Don't think you can avoid having deductions disallowed just because your PPP loan has not yet been forgiven, says the IRS.** Rev. Rul. 2020-27, 2020-50 I.R.B. ___ (11/18/20). Following the IRS's issuance of Notice 2020-32, which provides that costs are not deductible to the extent they are paid with the proceeds of a PPP loan that is forgiven, many taxpayers questioned whether they could take deductions for costs paid in 2020 with the proceeds of a PPP loan if the loan is not forgiven in 2020. In this revenue ruling, the IRS has crushed the hopes of many taxpayers. According to the ruling:

> A taxpayer … [that paid expenses with the proceeds of a PPP loan] may not deduct those expenses in the taxable year in which the expenses were paid or incurred *if, at the end of such taxable year, the taxpayer reasonably expects to receive forgiveness of the covered loan* on the basis of the expenses it paid or accrued during the covered period."

(Emphasis added.) The revenue ruling illustrates this rule in two situations. In the first, the taxpayer paid qualifying costs (payroll, mortgage interest, utilities, and rent) in 2020 with the proceeds of a PPP loan, satisfied all requirements for forgiveness of the loan, and applied for forgiveness of the loan, but the lender did not inform the taxpayer by the end of 2020 whether the loan would be forgiven. In the second situation, the facts were the same except that the taxpayer did not apply for forgiveness of the loan in 2020 and instead expected to apply for forgiveness of the loan in 2021. The ruling concludes that, in both situations, the taxpayers have a reasonable expectation that their loans will be forgiven and therefore cannot deduct the expenses they paid with the proceeds of their PPP loans. The ruling relies on two distinct lines of authority to support this conclusion. One line involves taxpayers whose deductions are disallowed because they have a reasonable expectation of reimbursement at the time they pay the costs in question. *See, e.g.*, *Burnett v. Commissioner*, 356 F.2d 755 (5th Cir. 1966) (attorney who advanced costs for client and was entitled to reimbursement if successful in the client's matter); *Canelo v. Commissioner*, 53 T.C. 217 (1969), *aff'd*, 447 F.2d 484 (9th Cir. 1971) (same). The IRS reasons in the ruling that the taxpayers in the two situations described have a reasonable expectation of reimbursement in the form of forgiveness of their PPP loans. The second line of authority is under § 265(a)(1), which disallows deductions for any amount otherwise deductible that is allocable to one or more classes of tax-exempt income regardless of whether the tax-exempt income is received or accrued. *See* Reg. § 1.265-1(a)(1), (b). Thus, according to the ruling, the fact that the loans in the two situations have not yet been forgiven does not preclude the costs paid by the taxpayers from being allocable to tax-exempt income.

**b. But taxpayers can deduct expenses paid with the proceeds of a PPP loan to the extent their applications for loan forgiveness are denied or to the extent they decide not to seek forgiveness of the loan.** Rev. Proc. 2020-51, 2020-50 I.R.B. ___ (11/18/20). This revenue procedure provides a safe harbor that allows taxpayers to claim deductions in a taxable year beginning or ending in 2020 for otherwise deductible expenses paid with proceeds of a PPP loan that the taxpayer expects to be forgiven after 2020 to the extent that, after 2020, the taxpayer's request for loan forgiveness is denied or the taxpayer decides not to request loan forgiveness. The deductions can be claimed on a timely filed (including extensions) original 2020 income tax return or information return, an amended 2020 return (or, in the case of a partnership, an administrative adjustment request for 2020), or timely filed original income tax return or information return for the subsequent year in which the request for loan forgiveness is denied or in which the taxpayer decides not to seek loan forgiveness. The deductions the taxpayer claims cannot exceed the principal amount of the PPP loan for which forgiveness was denied or will not be sought. To be eligible for the safe harbor, the taxpayer must attach a statement (titled "Revenue Procedure 2020-51 Statement") to the return on which the taxpayer claims the deductions. The statement must include information specified in the revenue procedure. The revenue procedure seems to acknowledge that, for taxpayers claiming the deductions in the subsequent taxable year in which loan forgiveness is denied, the safe harbor is unnecessary because such taxpayers would be able to deduct the expenses in the subsequent taxable year under general tax principles.

### E. Depreciation & Amortization

### F. Credits

### G. Natural Resources Deductions & Credits

### H. Loss Transactions, Bad Debts, and NOLs

### I. At-Risk and Passive Activity Losses

## III. INVESTMENT GAIN AND INCOME

### A. Gains and Losses

### B. Interest, Dividends, and Other Current Income

### C. Profit-Seeking Individual Deductions

**1. Say it isn't so! Miscellaneous itemized deductions are no longer deductible beginning in 2018.** The 2017 Tax Cuts and Jobs Act, § 11045, amended Code § 67 by adding § 67(g), which disallows as deductions all miscellaneous itemized deductions for taxable years beginning after 2017 and before 2026. Miscellaneous itemized deductions are defined in § 67(b) and, prior to the Tax Cuts and Jobs Act, were deductible to the extent that, in the aggregate, they exceeded 2 percent of the taxpayer's adjusted gross income. The largest categories of miscellaneous itemized deductions are: (1) investment-related expenses such as fees paid for investment advice or for a safe deposit box used to store investment-related items, (2) unreimbursed employee business expenses, and (3) tax preparation fees.

**a. But estates and non-grantor trusts can breathe a sigh of relief.** Notice 2018-61, 2018-31 I.R.B. 278 (07/13/18). Under § 67(e), the adjusted gross income of an estate or trust generally is computed in the same manner as that of an individual. Furthermore, prior to the Tax Cut and Jobs Act, estates and non-grantor trusts were subject to the 2 percent floor on miscellaneous itemized deductions like individuals *unless* a cost paid or incurred by the estate or non-grantor trust "would not have been incurred if the property were not held in such estate or trust." Put differently, estates and non-grantor trusts avoided the 2 percent floor on miscellaneous itemized deductions if they paid or incurred a cost that "commonly or customarily" would not have been paid or incurred by a hypothetical individual holding the same property as the estate or non-grantor trust. For example, Reg. § 1.67-4(b)(3) provides as follows:

> Tax preparation fees. Costs relating to all estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent's final individual income tax returns are not subject to the 2-percent floor. The costs of preparing all other tax returns (for example, gift tax returns) are costs commonly and customarily incurred by individuals and thus are subject to the 2-percent floor.

If a fee (such as a tax preparation fee) paid or incurred by an estate or non-grantor trust was bundled so that it included costs that were both subject to the 2 percent floor (e.g., gift tax return) and not subject to the 2 percent floor (e.g., fiduciary income tax return), then the estate or non-grantor trust must allocate the bundled fee appropriately.

The enactment of new § 67(g), which states that "no miscellaneous itemized deduction" is allowed until 2026, left many estates and trusts wondering whether their investment-related and tax-related expenses (e.g., return preparation fees, trustee fees, financial advisor fees, etc.) peculiar to the administration of an estate or trust remain deductible either in whole or in part. Notice 2018-61 announces that Treasury and the IRS do not read new § 67(g) to disallow all investment- and tax-related expenses of estates and non-grantor trusts. Thus, the Treasury Department and the IRS intend to issue regulations clarifying that estates and non-grantor trusts may continue to deduct investment- and tax-related expenses just as they could prior to the enactment of new § 67(g). Notice 2018-61 also announces that Treasury and the IRS are aware of concerns surrounding whether new § 67(g) impacts a beneficiary's ability to deduct investment- and tax-related expenses pursuant to § 642(h) (unused loss carryovers and excess deductions) upon termination of an estate or non-grantor trust. Treasury and the IRS intend to issue regulations addressing these concerns as well.

**b. IRS issues final regulations clarifying that certain deductions allowed to an estate or non-grantor trust are not miscellaneous itemized deductions.** T.D. 9918, Effect of Section 67(g) on Trusts and Estates, 85 F.R. 66219 (10/19/20). The Treasury Department and the IRS have finalized proposed regulations clarifying that deductions described in § 67(e)(1) and (2) are not miscellaneous itemized deductions (REG-113295-18, Effect of Section 67(g) on Trusts and Estates, 85 F.R. 27693 (5/11/20)). The final regulations amend Reg. § 1.67-4 to clarify that § 67(g) does not deny deductions described under § 67(e)(1) and (2) for estates and nongrantor trusts. These deductions generally include administration expenses of the estate or trust which would not have been incurred if the property were not held in the trust or estate and the personal exemption deduction of an estate or non-grantor trust. Such deductions are allowable in arriving at adjusted gross income (AGI) and are not considered miscellaneous itemized deductions under § 67(b). The regulations specifically do not address whether such deductions will continue to be deductible for purposes of the alternative minimum tax.

The final regulations also provide guidance under § 642(h) in relation to net operating loss and capital loss carryovers under subsection (h)(1) and the excess deductions under (h)(2). They implement a more specific method aimed at preserving the tax character of three categories of expenses. Thus, fiduciaries are required to separate deductions into at least the following three categories: (1) deductions allowed in arriving at adjusted gross income, (2) non-miscellaneous itemized deductions, and (3) miscellaneous itemized deductions. Under this regime, each deduction comprising the § 642(h)(2) excess deductions retains its separate character which passes through to beneficiaries on termination of the estate or trust. Separately stating these categories of expenses facilitates proper reporting by beneficiaries.

The regulations adopt the principles used under Reg. § 1.652(b)-3 in allocating items of deduction among the classes of income in the final year of a trust or estate for purposes of determining the character and amount of the excess deductions under section 642(h)(2). In general, Reg. § 1.652(b)-3 provides that deductions attributable to a particular class of income retain their character. Any remaining deductions that are not directly attributable to a specific class of income are allocated to any item of income (including capital gains) with a portion allocated to any tax-exempt income. See Reg. § 1.652(b)-3(b), (d). The character and amount of each deduction remaining represents the excess deductions available to the beneficiaries. The proposed regulations provide a useful example for determining the character of excess deductions.

The final regulations apply to taxable years beginning after October 19, 2020. Taxpayers can choose to apply the final regulations to all taxable years beginning after 2017 or can apply the proposed regulations to taxable years beginning after 2017 and before October 19, 2020. The prior regulations had treated excess deductions on termination as miscellaneous itemized deductions. Some commenters had requested that taxpayers be able to apply the new regulations to all open tax years, which would allow filing claims for refund for years in which excess deductions had been treated as miscellaneous itemized deductions. The preamble to the final regulations indicates that taxpayers cannot rely on either the proposed or final regulations for open tax years beginning before 2018 (the effective date of § 67(g)).

### D. Section 121

### E. Section 1031

### F. Section 1033

### G. Section 1035

### H. Miscellaneous

## IV. COMPENSATION ISSUES

### A. Fringe Benefits

### B. Qualified Deferred Compensation Plans

**1. Some inflation-adjusted numbers for 2021.** Notice 2020-79, 2020-46 I.R.B. 1014 (10/26/20).

- Elective deferrals in §§ 401(k), 403(b), and 457 plans remain unchanged at $19,500 with a catch-up provision for employees aged 50 or older that remains unchanged at $6,500.

- The limit on contributions to an IRA remains unchanged at $6,000. The AGI phase-out range for contributions to a traditional IRA by employees covered by a workplace retirement plan is increased to $66,000 to $76,000 (from $65,000-$75,000) for single filers and heads of household, increased to $105,000-$125,000 (from $104,000-$124,000) for married couples filing jointly in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, and increased to $198,000-$208,000 (from $196,000-$206,000) for an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered. The phase-out range for contributions to a Roth IRA is increased to $198,000-$208,000 (from $196,000-$206,000) for married couples filing jointly, and increased to $125,000-$140,000 (from $124,000-$139,000) for singles and heads of household.

- The annual benefit from a defined benefit plan under § 415 remains unchanged at $230,000.

- The limit for defined contribution plans is increased to $58,000 (from $57,000).

- The amount of compensation that may be taken into account for various plans is increased to $290,000 (from $285,000), and is increased to $430,000 (from $425,000) for government plans.

- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to $66,000 (from $65,000) for married couples filing jointly, increased to $49,500 (from $48,750) for heads of household, and increased to $33,000 (from $32,500) for singles and married individuals filing separately.

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

### D. Individual Retirement Accounts

## V. PERSONAL INCOME AND DEDUCTIONS

### A. Rates

### B. Miscellaneous Income

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

### D. Deductions and Credits for Personal Expenses

**1. 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.
>
> 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.

**g. State and local taxes imposed on and paid by a partnership or S corporation are not subject to the state and local tax deduction limitation for partners and shareholders who itemize deductions.** Notice 2020-75, 2020-49 I.R.B. 1453 (11/9/20). This notice announces that the Treasury Department and the IRS will issue proposed regulations clarifying that state and local income taxes imposed on and paid by a partnership or S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment. Therefore, such taxes are not subject to the $10,000 state and local tax deduction limitation for partners and shareholders who itemize deductions. The proposed regulations will apply to payments of taxes made on or after November 9, 2020. The proposed regulations also will allow taxpayers to apply these rules to specified income tax payments made in a taxable year of a partnership or an S corporation ending after Dec. 31, 2017, and before November 9, 2020.

**2. Dependency defined! Treasury releases final regulations clarifying the definition of a "qualifying relative"** T.D. 9913, Dependent Defined, 85 F.R. 64383 (10/13/20). Treasury and the IRS have finalized proposed regulations issued in 2020 that revised prior proposed regulations issued in January 2017 to clarify the definition of who is a "qualifying relative" for tax years 2018 through 2025. REG-118997-19, Dependent Defined; Notice of Proposed Rulemaking and Partial Withdrawal of Notice of Proposed Rulemaking, 85 F.R. 35233 (6/9/20). 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 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 a qualifying relative. Notice 2018-70, 2018-38 I.R.B. 441. Newly finalized Reg. § 1.152-2(e)(3) provides:

> In defining a qualifying relative for taxable year 2018, the exemption amount in section 152(d)(1)(B) is $4,150. For taxable 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, Reg. § 1.152-3(e)(1) provides for an inflation adjusted exemption amount for 2019-2025. Treasury argues that this language in the newly finalized 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.

**3. Standard deduction for 2021.** Rev. Proc. 2020-45, 2020-46 I.R.B. 1016 (10/26/20). The standard deduction for 2021 will be $25,100 for joint returns and surviving spouses (increased from $24,800), $12,550 for unmarried individuals and married individuals filing separately (increased from $12,400), and $18,800 for heads of households (increased from $18,650). For individuals who can be claimed as dependents, the standard deduction cannot exceed the greater of $1,100 or the sum of $350 and the individual's earned income (unchanged from 2020). The additional standard deduction amount for those who are legally blind or who are age 65 or older is $1,700 (increased from $1,650) for those with the filing status of single or head of household (and who are not surviving spouses) and is $1,350 (increased from $1,300) for married taxpayers ($2,700 on a joint return if both spouses are age 65 or older).

### E. Divorce Tax Issues

### F. Education

### G. Alternative Minimum Tax

## VI. CORPORATIONS

### A. Entity and Formation

### B. Distributions and Redemptions

### C. Liquidations

### D. S Corporations

**1. If you're a cash-method S corp pining to be a C corp, here's your chance!** The 2017 Tax Cuts and Jobs Act, § 13543, added new § 481(d) and new § 1371(f) to make it easier for cash-method S corporations to convert to C corporations (which typically, but not always, especially after TCJA's revisions to § 448, are accrual-method taxpayers). Specifically, new § 481(d) provides that any adjustment (such as changing from the cash to the accrual method) otherwise required under § 481(a)(2) with respect to an S to C conversion may be taken into account ratably over six years starting with the year of the change (instead of taking into account the adjustment entirely in the year of change) if three conditions are met: (i) the converting S corporation existed prior to December 22, 2017 (the date of TCJA's enactment); (ii) the conversion from S to C status takes place prior to December 22, 2019 (two years from the date of TCJA's enactment); and (iii) all of the shareholders of the S corporation on December 22, 2017, are "in identical proportions" the shareholders of the C corporation. A subchapter C corporation that meets these requirements is referred to in § 481(d)(2) as an "eligible terminated S corporation." New § 1371(f) further provides that "money" distributed by the above-described converted S corporations *after* the "post-termination transition period" (generally one year) is allocable to and chargeable against the former S corporation's accumulated adjustments account ("AAA") in the same ratio as AAA bears to accumulated earnings and profits ("E&P"). Thus, new § 1371(f) is more favorable to S corporations converting to C status than the normal rule of § 1371(e), which allows distributions of money *during* the "post-termination transition period," but not after, to be allocable to and chargeable against AAA. As a practical matter, then, S corporations converting to C corporations within the confines of new § 481(d) and § 1371(f) may make nontaxable, stock-basis reducing distributions of money out of their AAA during the one-year period following the conversion (pursuant to § 1371(e)) as well as wholly or partially (depending upon AAA as compared to E&P) nontaxable, basis-reducing distributions of money after the normal one-year, post-termination transition period. These changes to § 481 and § 1371 are permanent, but of course, will apply only to S to C conversions that meet the criteria of § 481(d) (i.e., pre-TCJA existing S corporations that convert to C status before December 22, 2019, and that have the same shareholders in the same proportions post-conversion).

**a. Guidance concerning the adjustments required under new § 481(d).** Rev. Proc. 2018-44, 2018-37 I.R.B. 426 (9/10/18) modifies Rev. Proc. 2018-31, 2018-22 I.R.B. 637, to provide that an "eligible terminated S corporation," as defined in § 481(d)(2), required to change from the overall cash method of accounting to an overall accrual method of accounting as a result of a revocation of its S corporation election, and that makes this change in method of accounting for the C corporation's first taxable year after such revocation, is required to take into account the resulting positive or negative adjustment required by § 481(a)(2) ratably during the six-year period beginning with the year of change. Rev. Proc. 2018-44 also provides that an eligible terminated S corporation permitted to continue to use the cash method after the revocation of its S corporation election, and that changes to an overall accrual method for the C corporation's first taxable year after such revocation, may take into account the resulting positive or negative adjustment required by § 481(a)(2) ratably during the six-year period beginning with the year of change.

**b. Final regulations for eligible terminated S corporations "ETSCs."** T.D. 9914, Eligible Terminated S Corporations, 85 F.R. 66471 (10/20/20). The Treasury Department and the IRS have finalized proposed regulations that provide guidance on the definition of an eligible terminated S corporation in § 481(d)(2) and rules relating to distributions of money by such a corporation after the post-termination transition period. REG-131071-18, Proposed Regulations Regarding Eligible Terminated S Corporations, 84 F.R. 60011 (11/7/19). As noted above, one of the requirements for "eligible terminated S corporation" status is conversion to C corporation status before December 22, 2019. For those S corporations that met the deadline and otherwise satisfied the above-mentioned requirements of § 481(d)—and who consequently have earned the new moniker "ETSCs"—Treasury has issued further guidance in the form of final regulations. Generally, the final regulations provide rules regarding (i) the definition of an ETSC; (ii) distributions of money by an ETSC after the "post-termination transition period" ("PTTP"); and (iii) the allocation of current C corporation earnings and profits to distributions of money and other property to the shareholders of ETSCs. The final regulations apply to tax years beginning after October 20, 2020, but corporations can choose to apply Reg. §§ 1.481-5, 1.1371-1, and 1.1371-2 in their entirety to tax years beginning on or before that date. We commend these regulations to further study by those tax advisors with affected clients.

## 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.

- 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.*

**a. To be a nontaxable contribution to capital, the contributions must become a permanent part of the recipient's capital structure, says the Third Circuit. The Tax Court's decision is reversed.** Commissioner v. Brokertec Holdings, Inc., 967 F.3d 317 (3d Cir. 7/28/20), *rev'g*, T.C. Memo. 2019-32 (4/9/19). In an opinion by Judge Ambro, the U.S. Court of Appeals for the Third Circuit has reversed the Tax Court's decision and held that the $55.7 million of cash grants received by two members of the consolidated group of which the taxpayer was the common parent from the State of New Jersey's Economic Development Plan were not nontaxable, nonshareholder contributions to capital under § 118. Instead, the court held, the members receiving the payments had to include them in gross income. According to the Third Circuit, the Tax Court's finding that the grants were contributions to capital "was predicated on a misunderstanding of Internal Revenue Code § 118 as well as the Treasury Regulation and cases interpreting the statutory provision." In the Third Circuit's view, the fact that a governmental entity provides the grant as an inducement for the corporation to relocate is not, by itself, enough to establish that the transferor's intent is to make a contribution to the corporation's capital. The court relied on the U.S. Supreme Court's decision in *United States v. Chicago, Burlington & Quincy R.R. Co.*, 412 U.S. 401 (1973), which established five characteristics of a nonshareholder contribution to capital. The first four of these characteristics have been interpreted by some courts to be requirements that all must be satisfied for a payment to constitute a contribution to capital. See *AT&T, Inc. v. United States*, 629 F.3d 505, 513 (5th Cir. 2011). The government argued that the first two characteristics were not present. These are: (1) the payment must become a permanent part of the recipient's working capital structure, and (2) the payment must not be compensation for services provided by the recipient. The Third Circuit declined to address whether the second characteristic was present and instead held that the cash grants received in this case did not satisfy the first characteristic. This characteristic is not present, the court held, when, as here, the cash grants are provided without any restriction on their use. The court reviewed a line of cases beginning with *Edwards v. Cuba Railroad Company*, 268 U.S. 628 (1925), and including both *Brown Shoe Co. v. Commissioner*, 339 U.S. 583 (1950), and its own decision in *Commissioner v. McKay Prods. Corp.*, 178 F.2d 639 (3d Cir. 1949). Based on this review, the Third Circuit concluded that a payment becomes a permanent part of the recipient's working capital structure only when the payment is "in some way … designated for use as capital—whether by an explicit restriction on the use of the funds, or by tying the amount of funds to the amount of a capital investment required of the company. Otherwise, the government payments are merely intended as supplements to income." In this case, the court observed, the cash grants were unrestricted. The corporations receiving the grants were free to use the funds to pay operating expenses such as wages or to pay dividends and the amounts of the grants were calculated based on the amount of wages paid to employees rather than on the amount of capital investments to be made. The court declined to remand the case to the Tax Court for application of the correct legal standard because "the record here permits only one resolution: New Jersey's Incentive Program grants to BrokerTec were intended as a supplement to its income rather than as a contribution to its capital." Accordingly, the court held, the corporations receiving the grants had to include them in gross income.

- 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 the same (but for a different reason) if the years involved had been subject to amended § 118.

## VII. PARTNERSHIPS

### A. <u>Formation and Taxable Years</u>

### B. <u>Allocations of Distributive Share, Partnership Debt, and Outside Basis</u>

### C. <u>Distributions and Transactions Between the Partnership and Partners</u>

### D. <u>Sales of Partnership Interests, Liquidations and Mergers</u>

### E. <u>Inside Basis Adjustments</u>

### F. <u>Partnership Audit Rules</u>

### G. <u>Miscellaneous</u>

**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.

**e. The draft instructions for Form 1065 and Schedule K-1 for 2020 require reporting tax basis capital accounts using a transactional approach.** IR-2020-240 (10/22/19). The IRS has released draft instructions for the 2019 Form 1065 and draft instructions for the 2019 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 2020 draft instructions for Form 1065 and Schedule K-1 require partnerships to report each partner's capital account on a tax basis regardless of whether the account is negative. Further, each partner's tax capital account must be determined using a transactional approach. For partnerships that reported capital accounts on a tax basis in the prior year (and those that did not report tax capital accounts but maintained tax basis capital accounts in their books and records), a partner's beginning tax capital account generally will be the partner's ending tax capital account from the prior year, or zero for a partner that acquired his or her partnership interest by making a contribution during the year, or the transferor partner's capital account for a partner that acquired his or her partnership interest during the year from another partner. For partnerships that did not report tax basis capital accounts in the prior year and did not maintain tax capital accounts in their books and records, a partner's beginning tax capital account can be determined for this year only using the tax basis method (presumably a transactional approach) or one of three alternative methods. These alternative methods are the (1) modified outside basis method, (2) modified previously taxed capital method, or (3) section 704b) method. The first two of these methods were proposed in Notice 2020-43, discussed above. Under the section 704(b) method, the amount to report as the partner's beginning tax capital account is equal to the partner's § 704(b) book capital account, minus the partner's share of built-in gain that would be allocated to the partner under § 704(c) plus the partner's share of built-in loss that would be allocated to the partner under § 704(c) if the partnership were to sell its assets. Such allocations of built-in gain or loss under §704(c) can result from 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).

## 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

**1. Up in Smoke: the period for filing petitions in the Tax Court had expired for these medical marijuana dispensaries. The lesson: for God's sake, when you are filing the petition on the last possible day, use registered or certified mail or make sure you are using a designated private delivery service.** Organic Cannabis Foundation, LLC v. Commissioner, 962 F.3d 1082 (9th Cir. 6/18/20). In an opinion by Judge Collins, the U.S. Court of Appeals for the Ninth Circuit has affirmed the Tax Court's dismissal of two cases for lack of jurisdiction. The IRS issued notices of deficiency to two taxpayers, Organic Cannabis Foundation, LLC, a limited liability company, and Northern California Small Business Assistants, Inc., a corporation. Both taxpayers operated or held interests in medical marijuana dispensaries in California. The notices of deficiency disallowed deductions under § 280E, which disallows any deduction or credit otherwise allowable if such amount is paid or incurred in connection with a trade or business "if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances …." The last day for filing petitions in the Tax Court seeking redeterminations of the deficiencies was April 22, 2015. The law firm representing the taxpayers filed petitions in the Tax Court by sending them on April 21, 2015, using Federal Express's "First Overnight" delivery service, which should have resulted in the earliest possible delivery on April 22. The petitions, however, were not delivered by Federal Express to the Tax Court until April 23. The delivery notes made by the Federal Express driver indicated that he or she had attempted delivery on April 22 but "could not get to the door for some plausible reason like construction, or some sort of police action (perhaps the [Federal Express] representative said the access was blocked off because of a safety threat)." The Tax Court granted the government's motion to dismiss for lack of jurisdiction because the taxpayers had not filed the petitions within the 90-day period prescribed by § 6213(a). On appeal, the Ninth Circuit affirmed. In reaching this conclusion, the court rejected four arguments made by the taxpayers. *First*, the taxpayers argued that the filing deadline had been extended to April 23 because the Tax Court clerk's office was inaccessible on April 22, the last day for filing. In *Guralnik v. Commissioner*, 146 T.C. 230 (2016), the Tax Court had concluded that a petition filed on the day after the last day for filing was timely by virtue of Federal Rule of Civil Procedure 6(a)(3)(A), which provides that, if the clerk's office is inaccessible on the last day for filing, then the time for filing is extended to the first day that is not a Saturday, Sunday, or legal holiday on which the clerk's office is accessible. In *Guralnik*, the Tax Court was closed due to a snowstorm on the last day for filing the petition. In this case, the Ninth Circuit concluded, the Tax Court clerk's office was not inaccessible on April 22. According to the court, "a temporary obstacle that is encountered *earlier* in the day does not, without more, render the clerk's office 'inaccessible' on 'the last *day* for filing.'" For non-electronic filings such as the petitions in this case, the court held,

> a clerk's office is "inaccessible" on the "last day" of a filing period only if the office cannot practicably be accessed for delivery of documents during a sufficient period of time up to and including the point at which "the clerk's office is scheduled to close."

*Second*, the taxpayers argued that their petitions were timely filed pursuant to the timely-mailed-is-timely-filed rule of § 7502(a). Section 7502(a) provides that the postmark stamped on the cover in which a return, claim, or other document is mailed is deemed to be the date of delivery if the return or claim (1) is deposited in the mail in the United States within the time prescribed for filing in a properly addressed, postage prepaid envelope or other appropriate wrapper and bears a postmark date that falls within the time prescribed for filing, and (2) is delivered by United States mail after the prescribed time for filing to the agency with which it is required to be filed. This rule is extended by § 7502(f) to any document sent through a "designated private delivery service," defined in 7502(f)(2) as any delivery service that meets certain requirements and is provided by a trade or business if the service is designated for this purpose by the Secretary of the Treasury. At the time the petitions in this case were filed, the IRS had specified which delivery services were designated private delivery services in Notice 2004-83, 2004-52 I.R.B. 1030. Although Notice 2004-83 listed several Federal Express services as designated private delivery services, Federal Express "First Overnight" was not among them. Accordingly, the court held, the taxpayers could not rely on § 7502(a) to establish that their petitions had been timely filed and the Tax Court had correctly dismissed the cases for lack of jurisdiction. *Third*, the taxpayers argued that the 90-day period specified in § 6213(a) for filing a petition in the Tax Court seeking redetermination of a deficiency is subject to equitable exceptions such as equitable tolling. The court, however, adhered to controlling Ninth Circuit precedent in which the court previously had held that this 90-day period is jurisdictional and not subject to equitable exceptions. The court rejected the taxpayers' argument that recent decisions of the U.S. Supreme Court addressing when statutory deadlines should be deemed jurisdictional had undermined the Ninth Circuit's settled precedent. *Fourth*, Organic Cannabis Foundation, LLC, argued that the notice of deficiency issued by the IRS was invalid because it had not been mailed to the taxpayer's last known address as required by § 6212(b)(1). The court rejected this argument because, although the address to which the notice had been mailed omitted the taxpayer's P.O. Box number, the nine-digit zip code included in the address indicated both that it was to be delivered to a P.O. Box and the specific number of the box to which it was addressed.

- Approximately two weeks after the petitions in this case were delivered to the Tax Court, the IRS updated the list of designated private delivery services to include Federal Express First Overnight. *See* Notice 2015-38, 2015-21 I.R.B. 984.

### F. <u>Liens and Collections</u>

**1. The 30-day period for requesting review in the Tax Court of a notice of determination following a CDP hearing is jurisdictional and not subject to equitable tolling.** Boechler, P.C. v. Commissioner, 967 F.3d 760 (8th Cir. 7/24/20), *aff'g* Boechler, P.C. v. Commissioner, No. 18578-17L (U.S. Tax Court (2/15/19)). Following a collection due process hearing, the IRS issued a notice of determination upholding proposed collection action. The notice informed the taxpayer that, if he wished to contest the determination, he could do so by filing a petition with the United States Tax Court within a 30-day period beginning the day after the date of the letter. The IRS mailed the notice on July 28, 2017. The 30-day period expired on August 27, 2017, but because this date fell on a Sunday, the taxpayer had until the following day, August 28, to file his petition. The taxpayer mailed his petition to the Tax Court on August 29, 2017, which was one day late. The Tax Court (Judge Carluzzo) granted the government's motion to dismiss for lack of subject matter jurisdiction. On appeal, the taxpayer argued that the 30-day period specified in § 6330(d)(1) for filing his Tax Court petition should be equitably tolled. In an opinion by Judge Erickson, the U.S. Court of Appeals for the Eighth Circuit affirmed the Tax Court's decision. The court held that the 30-day period specified in § 6330(d)(1) is jurisdictional and therefore is not subject to equitable tolling. In reaching this conclusion, the court relied on the plain language of § 6330(d)(1), which provides:

> A person may, within 30 days of a determination under this section, petition the Tax Court for review of such determination (and the Tax Court shall have jurisdiction with respect to such matter).

This provision, the court reasoned, "is a rare instance where Congress clearly expressed its intent to make the filing deadline jurisdictional." According to the court, the parenthetical expression regarding the Tax Court's jurisdiction "is clearly jurisdictional and renders the remainder of the sentence jurisdictional." Because the 30-day period specified in § 6330(d)(1) is jurisdictional, the court concluded, it is not subject to equitable tolling. In reaching this conclusion, the court found persuasive the reasoning of the U.S. Court of Appeals for the Ninth Circuit in *Duggan v. Commissioner*, 879 F.3d 1029 (9th Cir. 2018), in which the Ninth Circuit similarly held that the 30-day period specified in § 6330(d)(1) is jurisdictional and therefore not subject to equitable tolling. *See also Cunningham v. Commissioner*, 716 Fed. Appx. 182 (4th Cir. 2018) (holding that, assuming without deciding that the 30-day period specified in § 6330(d)(1) is not jurisdictional and therefore is subject to equitable tolling, the taxpayer had not established circumstances warranting equitable tolling). The Eighth Circuit found unpersuasive the taxpayer's reliance on *Myers v. Commissioner*, 928 F.3d 1025 (D.C. Cir. 2019), in which the D.C. Circuit held that a similarly worded 30-day limitations period in § 7623(b)(4) for filing a Tax Court petition to challenge an adverse IRS determination regarding entitlement to a whistleblower award was not jurisdictional and was subject to equitable tolling.

### G. Innocent Spouse

### H. Miscellaneous

## XI. WITHHOLDING AND EXCISE TAXES

## XII. TAX LEGISLATION

### A. Enacted