RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

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State Bar of Texas Tax Section
First Wednesday Tax Update
June 2, 2021

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I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

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

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

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

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

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

Employer Pays a Third Party for Employee Parking Spots. According to the notice, in situations in which an employer pays a third party an amount so that employees may park at the third party's parking lot or garage, the amount disallowed by § 274(a)(4) generally is the taxpayer's total annual cost of employee parking paid to the third party. Nevertheless, if the amount paid by the employer exceeds the § 132(f)(2) monthly limitation on exclusion ($265 for 2019 and $270 for 2020), the employer must treat the excess amount as compensation and wages to the employee. Accordingly, the excess amount is not disallowed as a deduction pursuant to § 274(e)(2), which provides that § 274(a) does not disallow a deduction for an expense relating to goods, services, and facilities to the extent the taxpayer treats the expense as wages paid to its employees. The result is that the employer can deduct the monthly cost of parking provided to an employee to the extent the cost exceeds the § 132(f)(2) monthly limitation. These rules are illustrated by examples 1 and 2 in the notice.

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

b. Who knew that determining the tax consequences of providing parking or transportation to employees could get so complicated? Final regulations address determining the

nondeductible portion of qualified transportation fringe benefits. T.D. 9939, Qualified Transportation Fringe, Transportation and Commuting Expenses Under Section 274, 85 F.R. 81391 (12/16/20). The Treasury Department and the IRS have finalized proposed regulations (REG-119307-19, Qualified Transportation Fringe, Transportation and Commuting Expenses Under Section 274, 85 F.R. 37599 (6/23/20)) that implement two legislative changes made by section 13304(c) of the 2017 Tax Cuts and Jobs Act, which added § 274(a)(4) and § 274(l) to the Code. Section 274(a)(4) disallows the deduction of any "qualified transportation fringe" (as defined in § 132(f)) provided to an employee of the taxpayer in taxable years beginning after 2017. A qualified transportation fringe is any of the following provided by an employer to an employee. (1) transportation in a commuter highway vehicle in connection with travel between the employee's residence and place of employment, (2) any transit pass, (3) qualified parking, and (4) any qualified bicycle commuting reimbursement. Section 274(*l*) disallows the deduction of any expense incurred for providing any transportation (or any payment or reimbursement) to an employee of the taxpayer in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee, but does not disallow any qualified bicycle commuting reimbursement (as described in section 132(f)(5)(F)) paid or incurred after 2017 and before 2026.

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

Employer Pays a Third Party for Employee Parking Spots. According to Reg. § 1.274-13(d)(1), in situations in which an employer pays a third party an amount so that employees may park at the third party's parking lot or garage, the amount disallowed by § 274(a)(4) generally is the taxpayer's total annual cost of employee parking paid to the third party. Nevertheless, under Code § 274(e)(2) and Reg. § 1.274-13(e)(1) and -13(e)(2), the disallowance of deductions for qualified transportation fringes does not apply to an expense relating to goods, services, and facilities to the extent the taxpayer treats the expense as wages paid to its employees. Accordingly, if the amount paid by the employer exceeds the § 132(f)(2) monthly limitation on the employee's exclusion ($265 for 2019 and $270 for 2020), the employer must treat the excess amount as compensation and wages to the employee. The excess amount is not disallowed as a deduction provided that the employer treats the expense both as compensation on its federal income tax return and as wages subject to withholding. The result is that the employer can deduct the monthly cost of parking provided to an employee to the extent the cost exceeds the § 132(f)(2) monthly limitation. These rules are illustrated by examples 1 and 2 in Reg. § 1.274-13(f).

Taxpayer Owns or Leases All or a Portion of a Parking Facility. Under Reg. § 1.274-13(d)(2), if a taxpayer owns or leases all or a portion of one or more parking facilities where employees park, the nondeductible portion of the cost of providing parking can be calculated using either a general rule or one of three simplified methodologies. Under the general rule, an employer can determine the nondeductible portion of parking expenses "based on a reasonable interpretation of section 274(a)(4)." A method will not be treated as based on a reasonable interpretation if it uses the *value* of parking provided to employees to determine parking expenses (because § 274(a)(4) disallows a deduction for the *expense* of providing a qualified transportation fringe), results in deducting expenses related to reserved employee spaces, or improperly applies the exception in § 274(e)(7) for qualified parking made available to the public (e.g., by treating a parking facility regularly used by employees as available to the public merely because the general public has access to the parking facility). There are three simplified methodologies that a taxpayer can use as an alternative to the general rule. *First*, a taxpayer can use the "qualified parking limit methodology," which determines the disallowed portion of parking costs by multiplying the § 132(f)(2) monthly limitation on the employee's exclusion ($265 for 2019 and $270 for 2020) for each month in the taxable year by the total number of spaces used by employees during the "peak demand period" (a defined term) or by number of employees. For example, an employer with 10 employees who provides parking to all of them each day for the full year would have $32,400 in disallowed parking costs (10 * $270 *12) for the year. This method is illustrated by example 3 in Reg. § 1.274-13(f). *Second*, a taxpayer can use the "primary use methodology," which is essentially the same as the four-step methodology provided in Notice 2018-99 that, according to the notice, is deemed to be a reasonable method of determining the nondeductible portion of parking costs. Under the four-step methodology provided in the notice, employers can determine the nondeductible portion of parking costs by: **(1)** determining the percentage of parking spots that are reserved exclusively for employees and treating that percentage of total parking expenses as disallowed; **(2)** determining whether the primary use of the remaining spots (greater than 50 percent actual or estimated usage) is providing parking to the general public, in which case the remaining portion of total parking expenses is not disallowed by § 274(a)(4); **(3)** if the primary use of the remaining parking spots (from step 2) is *not* to provide parking to the general public, identifying the number of remaining spots exclusively reserved for nonemployees, including visitors, customers, partners, sole proprietors, and 2-percent shareholders of S corporations and treating this percentage of total parking expenses as not disallowed by § 274(a)(4); and **(4)** if there are any remaining parking expenses not specifically categorized as deductible or nondeductible after completing steps 1-3, the taxpayer must reasonably allocate the remaining expenses by determining "the total number of available parking spaces used by employees during the peak demand period." This four-step methodology is illustrated by examples 4 through 9 in Reg. § 1.274-13(f). *Third*, a taxpayer can use the "cost per space methodology," which determines the disallowed portion of parking costs by multiplying the employer's cost per space (total parking expenses divided by total parking spaces) by the total number of available parking spaces used by employees during the peak demand period. As defined in Reg. § 1.274-13(b)(12), the term "*total parking expenses*," a portion of which is disallowed, includes, without limitation, "repairs, maintenance, utility costs, insurance, property taxes, interest, snow and ice removal, leaf removal, trash removal, cleaning, landscape costs, parking lot attendant expenses, security, and rent or lease payments or a portion of a rent or lease payment (if not broken out separately)." However, the term total parking expenses does *not* include a deduction for depreciation on a parking facility used for parking by the taxpayer's employees.

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

Effective dates. According to Reg. §§ 1.274-13(g) and § 1.274-14(d), the final regulations apply to taxable years that begin on or after December 16, 2020, the date on which the final regulations were published in the Federal Register. The preamble adds that taxpayers can rely on the proposed regulations or, alternatively, can rely on the guidance in Notice 2018-99 for taxable years beginning after December 31, 2017, and before December 16, 2020.

2. Regulations provide guidance under, but only hint as to the reason for, revised § 162(f) (fines, penalties, and other amounts). T.D. 9946, Denial of Deduction for Certain Fines, Penalties, and Other Amounts; Related Information Reporting Requirements, 86 F.R. 4970 (1/19/21). Recall that the 2017 Tax Cuts and Jobs Act, § 13306, amended Code § 162(f) effective on or after December 22, 2017, to disallow a deduction:

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

The amended statute is quite complicated, containing multiple exceptions and qualifications with respect to the general disallowance rule quoted above. For instance, § 162(f) does not disallow a deduction for any amount that either (i) is for restitution (including remediation of property) for damage or harm which was or may be caused by the violation of law or (ii) is paid to come into compliance with any law which was violated or otherwise involved in the investigation or inquiry into a violation of law. *See* § 162(f)(2)(A)(i). To meet either of the foregoing exception(s), though, the regulations specify that the taxpayer must satisfy two additional requirements: the *establishment requirement* and the *identification requirement*. *See* Reg. § 1.162-21(b)(1). The regulations elaborate on these two additional requirements, but essentially the payment must be identified as restitution or as paid to come into compliance with law and must be documented as such in a court order or a settlement agreement. *See* Reg. § 1.162-21(b)(2)-(3). Another exception provides that § 162(f) does not apply to any amount paid or incurred as taxes due (*see* § 162(f)(4)); however, restitution for failure to pay any tax imposed under the Code is deductible only if it would have been deductible if timely paid (e.g., employment taxes, but not federal income taxes). *See* § 162(f)(2)(A)(iii); Reg. § 1.162-21(c)(3). And yet another exception applies to amounts paid pursuant to a court order in a suit in which no government or governmental entity is a party (e.g., a court orders X to pay damages to Y when Y is not a government or governmental entity). *See* § 162(f)(3); Reg. 1.162-21(c)(1).

Why all the fuss? Neither the Conference Report nor the Joint Committee on Taxation's Bluebook explain why Congress felt the change to § 162(f) was necessary. *See* H.R. Conf. Rep. No. 115-466, at 430-431 (Dec. 15, 2017); Staff of the Joint Committee on Taxation, General Explanation of Public Law 115-97, at 193-194 (U.S. Gov't Publishing Off. Dec. 2018). Prior to amendment, § 162(f) stated only that "[n]o deduction shall be allowed … for any fine or similar penalty paid to a government for the violation of any law." Obviously, amended § 162(f) is considerably broader, but the pre-TCJA rule remains: no deduction for fines or penalties paid to a government for the violation of any law. The final regulations confirm this point, stating "an amount that is paid or incurred in relation to the violation of any civil or criminal law includes a fine or penalty." *See* Reg. § 1.162-21(a)(3)(i) ("). *The question therefore becomes how much broader is revised § 162(f)?*

Get to the point, will ya? Before going further into the weeds regarding § 162(f), we believe the upshot here is relatively straightforward. Due to revised § 162(f) and *corresponding information return requirements* (see below), taxpayers making court-ordered or settlement payments to government agencies must be very mindful of the new rules. If challenged by the IRS, taxpayers will need to demonstrate not only that the payment is not a fine or penalty, but also that the payment either (i) does not relate to a violation or potential violation of civil or criminal law or (ii) fits within one of the exceptions noted above. Attorneys and other advisors handling government investigations or litigation should become familiar with amended § 162(f) and the regulations thereunder. The regulations generally apply to taxable years beginning on or after January 19, 2021, except not to "amounts paid or incurred under any order or agreement pursuant to a suit, agreement, or otherwise, which became binding under applicable law before such date, determined without regard to whether all appeals have been exhausted or the time for filing appeals has expired." *See* Reg. § 1.162-21(g).

Beyond fines or penalties. Although as noted above neither Congress nor the Joint Committee on Taxation explains the rationale behind revised § 162(f), Treasury and IRS suggest a reason in the preamble to the proposed regulations. The preamble to the proposed regulations states that prior regulations under § 162(f) did not treat "compensatory damages paid to a government" as a disallowed fine or penalty. *See* REG-104591-18, Denial of Deduction for Certain Fines, Penalties, and Other Amounts; Information With Respect to Certain Fines, Penalties, and Other Amounts, 85 F.R. 28524 at 28525 (5/13/2020). Thus, the implication is that revised § 162(f) disallows a deduction for "compensatory" amounts paid to a government due to a violation of civil or criminal law. To wit, after defining the terms "suit, agreement, or otherwise," *see* Reg. § 1.162-21(e)(5), and "government or government entity," s*ee* Reg. § 1.162-21(e)(1) & (2), the final regulations provide an example of such a nondeductible "compensatory" payment:

> *Facts*. Corp. C contracts with governmental entity, Q, to design and build a rail project within five years. Site conditions cause construction delays and Corp. C asks Q to pay $50X in excess of the contracted amount to complete the project. After Q pays for the work, it learns that, at the time it entered the contract with Corp. C, Corp. C knew that certain conditions at the project site would make it challenging to complete the project within five years. Q sues Corp. C for withholding critical information during contract negotiations in violation of the False Claims Act (FCA). The court enters a judgment in favor of Q pursuant to which Corp. C will pay Q $50X in restitution and $150X in treble damages. Corp. C pays the $200X.
>
> *Analysis*. The suit pertains to Corp. C's violation of the FCA. The order identifies the $50X Corp. C is required to pay as restitution, as described in paragraph (b)(2) of this section. If Corp. C establishes, as provided in paragraph (b)(3) of this section, that the amount paid was for restitution, paragraph (a) of this section will not disallow Corp. C's deduction for the $50X payment. Under paragraph (a) of this section, Corp. C may not deduct the $150X paid for the treble damages imposed for violation of the FCA because the order did not identify all or part of the payment as restitution.

See Reg. 1.162-21(f)(8) Ex. 8. The regulations contain a total of thirteen examples. S*ee* Reg. § 1.162-21(f). The examples definitely are worth reading for advisors of taxpayers making any payments to government agencies that conceivably relate to violations or potential violations of law.

Reporting requirements. The regulations also provide guidance under new Code § 6050X, which dovetails with revised § 162(f). New § 6050X requires government agencies to report to the IRS and the taxpayer the amount of each settlement agreement or order entered into where the aggregate amount required to be paid or incurred to or at the direction of the government is at least $600 (or such other amount as may be specified by Treasury). *See* Reg. § 1.6050X-1. Affected government agencies will have to file Form 1098-F (Fines, Penalties, and Other Amounts) with Form 1096 (Annual Summary and Transmittal of U.S. Information Returns). The Form 1098-F will require payors to identify any amounts that are for restitution or remediation of property, or correction of noncompliance. The information reporting rules under § 6050X apply only to orders and agreements, pursuant to suits and agreements, which become binding under applicable law on or after January 1, 2022, determined without regard to whether all appeals have been exhausted or the time for filing an appeal has expired. Previously, Notice 2018-23, 2018-15 I.R.B. 474 (4/9/2018), had suspended any reporting requirement under § 6050X until a date was announced in the regulations.

3. Nice dreams. The Tax Court has rejected the taxpayer's arguments that § 280E does not disallow deductions for depreciation and charitable contributions. San Jose Wellness v. Commissioner, 156 T.C. No. 4 (2/17/21). The IRS disallowed the deductions of the taxpayer, a corporation that operated a medical marijuana dispensary, under § 280E. Section 280E disallows any deduction or credit otherwise allowable if such amount is "paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances …." The taxpayer challenged the disallowance on the grounds that § 280E does not disallow deductions for depreciation or charitable contributions. The Tax Court previously had rejected the argument that § 280E disallows only business expenses otherwise deductible under § 162 and not other deductions such as taxes deductible under § 164 or depreciation deductible under § 167. *See Northern California Small Business Assistants Inc. v. Commissioner,* 153 T.C. 65 (2019). In its previous decision, the court reasoned that both the language of § 280E, which provides that "[n]o deduction or credit shall be allowed," and the broader statutory scheme did not support that argument. Despite its prior decision, the court considered the taxpayer's arguments in this case because the taxpayer had "advanced more nuanced textual arguments …" The Tax Court (Judge Toro) acknowledged that § 280E disallows a taxpayer's deductions only if the following three conditions are satisfied:

- the deduction is for an amount *paid or incurred during the taxable year*;

- that amount was paid or incurred *in carrying on* any trade or business; and
- that trade or business (or the activities that comprise the trade or business) *consisted of* trafficking in certain defined controlled substances.

Depreciation. The taxpayer argued that § 280E does not disallow deductions for depreciation because depreciation does not satisfy the first of the three conditions required for § 280E to apply, i.e., depreciation is not "paid or incurred during the taxable year." Section 7701(a)(25) provides that "[t]he terms 'paid or incurred' and 'paid or accrued' shall be construed according to the method of accounting upon the basis of which the taxable income is computed under subtitle A." The taxpayer in this case was an accrual method taxpayer. The court rejected the taxpayer's argument. Among other authorities, the court relied on the U.S. Supreme Court's decision in *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974), in which the Court treated the taxpayer's depreciation deduction with respect to construction equipment as a capital expenditure because "*the cost, although certainly presently incurred*, is related to the future and is appropriately allocated as part of the cost of acquiring an income-producing capital asset." (emphasis added). The court also relied on its own decision in *Fort Howard Corp. v. Commissioner*, 103 T.C. 345 (1994), in which the court concluded that the taxpayer's amortization deductions were disallowed by § 162(k)(1), which provides that "no deduction otherwise allowable shall be allowed under this chapter for any amount paid or incurred by a corporation in connection with the reacquisition of its stock or of the stock of any related person …"

Charitable contributions. With respect to charitable contributions, the taxpayer argued that § 280E does not apply because such contributions do not satisfy the second of the three conditions required for § 280E to apply, i.e., they are not paid or incurred "in carrying on any trade or business." The taxpayer's apparent argument was that, although charitable contributions might be paid or incurred *in connection with* a trade or business, they are not paid or incurred *in carrying on* a trade or business within the meaning of §§ 162 and 280E. The court rejected this argument. The taxpayer, the court observed, "chose to contribute the amounts at issue here, and we see no reason to conclude that this action was somehow separate from, or outside the scope of, its business activities."

Consists of trafficking in controlled substances. The Tax Court also rejected the taxpayer's argument that the words "consists of" in § 280E mean that the statute applies only to businesses that exclusively or solely engage in trafficking in controlled substances and does not apply to businesses, like the taxpayer's, that also engage in other activities such as selling T-shirts and other noncannabis items and offering acupuncture, chiropractic, and other "holistic" services. The court previously had rejected this same argument in *Patients Mutual Assistance Collective Corp. v. Commissioner*, 151 T.C. 176 (2018), but the taxpayer nevertheless made the argument in order to preserve it for appeal.

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

D. Section 121

E. Section 1031

1. "Real property" defined, at least for purposes of Code § 1031. T.D. 9935, Statutory Limitations on Like-Kind Exchanges, 85 F. R. 77365 (12/2/20). For those of you who have been living under a rock, the 2017 Tax Cuts and Jobs Act, § 13303, amended § 1031(a)(1) so that the term "real property" was substituted for "property" for taxable years beginning after 2017. Thus, like-kind exchanges under § 1031 for 2018 and future years are limited to "real property." But what, exactly, qualifies as "real property" for this purpose? What about leasehold interests? What about personal property that is affixed to real property (e.g., escalators, sprinkler systems)? Is such personal property considered boot, and therefore taxable, if it is part of a like-kind exchange under revised IRC § 1031? Final regulations address these and other questions. In general, the regulations define the term "real property" to include land and permanent improvements to land (e.g., buildings), unsevered crops and other natural products of land, and water and air space superjacent to land. Improvements to land include inherently permanent structures (e.g., stadiums) and the structural components of inherently permanent structures (e.g., escalators; sprinkler systems; cell towers). Reg. § 1.1031(a)-3(a)(1).

Intangible interests in real property. Subject to the requirements of the regulations, the term "real property" also includes intangible interests in real property (e.g., a leasehold interest or option to acquire real estate). Reg. § 1.1031(a)-3(a)(5). Thus, a land use permit is considered real property under § 1031, but a license to operate a casino in a taxpayer's building is not § 1031 real property.

Impact of state and local law definitions of real property. Assets considered real property under state and local law (e.g., shares in a mutual ditch, reservoir, or irrigation company; stock in a cooperative housing corporation; a water pipeline) can meet the definition of "real property" under the regulations. Reg. § 1.1031(a)-3(a)(1) and (6). For example, the regulations provide that a like-kind exchange of a water pipeline defined under state law as real property for cell towers that may or may not be defined as real property under state law can qualify under § 1031. See Reg. 1.1031(a)-3(b) Ex. 10.

Personal property affixed to real property. With respect to personal property that is not an inherently permanent component of real property, the regulations adopt a multi-factor test to determine real property status under § 1031. The multi-factor test examines (1) the manner, time, and expense of installing and removing the component; (2) whether the component is designed to be moved; (3) the damage that removal of the component would cause to the item itself or to the inherently permanent structure to which it is affixed; and (4) whether the component is installed during construction of the inherently permanent structure. Examples in the regulations conclude that a large, indoor sculpture designed and installed specifically for the atrium of a building is considered real property under § 1031, whereas a modular drywall partition system within a building is not considered real property under § 1031. *Compare* Reg. 1.1031(a)-3(b) Ex. 3 *with* Ex. 8.

Effective date. The final regulations apply to exchanges beginning after December 2, 2020.

F. Section 1033

G. Section 1035

H. Miscellaneous

IV. COMPENSATION ISSUES

V. PERSONAL INCOME AND DEDUCTIONS

VI. CORPORATIONS

VII. PARTNERSHIPS

A. Formation and Taxable Years

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

1. ♫♪You got to know when to hold'em, know when to fold'em, know when to walk away, and know when to run….♫♪ Carried (a/k/a profits) interests still qualify for preferential long-term capital gain rates, but the holding period is three years for specified interests in hedge funds and other investment partnerships. The 2017 Tax Cuts and Jobs Act, § 13309, created new § 1061 and redesignated pre-TCJA § 1061 as § 1062. New § 1061 was Congress's lame attempt to close the carried interest (a/k/a profits interest) "loophole," under which managers of real estate, hedge fund, and other investment partnerships were taxed at preferential long-term capital gain rates (e.g., 20%) on their distributive shares of partnership income notwithstanding the fact that they received their interests in these partnerships as part of their compensation for services rendered (which compensation otherwise would be taxed at ordinary income rates). Essentially, § 1061 imposes a three-year holding period requirement before allocations of income or gain (including gain on disposition of an interest) with respect to an "applicable partnership interest" qualify for preferential long-term capital gain rates. An "applicable partnership interest" is one that is transferred to a taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any "applicable trade or business." An "applicable trade or business" means any activity conducted on a regular, continuous, and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of ''raising or returning capital," and either "investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition)," or ''developing specified assets." Specified assets for this purpose generally are defined as securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and (*big furrowed brow here*) "an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing" (e.g., tiered partnerships). There are significant exceptions, though, for (i) employees of another entity holding interests in a partnership that only performs services for that other entity; and (ii) partnership interests acquired for invested capital (including via an § 83(b) election for a capital interest in a partnership).

a. Thirty-four new defined terms created under the final regulations. T.D. 9945, Guidance Under Section 1061, 86 F.R. 5452 (1/19/21). Recently-issued final regulations clarify the application of § 1061 and answer several questions that had been raised by tax advisors and commentators; however, the regulations do so by creating no less than *34 defined terms*. These defined terms are too numerous and intertwined to summarize here. Suffice it to say for our purposes that new § 1061 works by transmuting (i) otherwise net long-term capital gain (as defined in § 1222) attributable to an "applicable partnership interest" (i.e., all of a taxpayer's net long-term capital gain as normally calculated) into short-term capital gain, but (ii) only to the extent such gain exceeds net long-term capital gain (as defined in § 1222) attributable to the disposition of partnership property (or a partnership interest) held by the partnership (or by the partner) for three years or more (i.e., net long-term gain that is excluded from transmutation under § 1061). The regulations define the above-described excess attributable to an applicable partnership interest ("API") as the "recharacterization amount." Reg. § 1.1061-4(a). Short- and long-term capital gains (or losses) attributable to an API ("API Gains and Losses") are determined at the partnership (or partner) level under § 1222 by reference to the disposition of a "capital asset" as defined in § 1221. Importantly, the regulations impose new reporting rules for APIs that take effect for taxable years beginning on or after January 19, 2021. *See* Reg. § 1.1061-6. For more details regarding the determination and reporting of API Gains and Losses, see the regulations, especially Reg. § 1.1061-4.

Section 1231 quasi-capital gains escape new § 1061. Recall that § 1221 excludes § 1231 assets from the definition of "capital assets." Thus, one question raised by tax advisors and commentators was whether API Gains and Losses subject to recharacterization under § 1061 would include § 1231 quasi-capital gains attributable to an API. The preamble to the final regulations answers this question in the negative, stating "API Gains and Losses do not include long-term capital gain determined under sections 1231 and 1256 [contracts marked to market], qualified dividends described in section 1(h)(11)(B), and any other capital gain that is characterized as long-term or short-term without regard to the holding period rules in section 1222." Of course, this considerably reduces the impact of new § 1061, especially with respect to real estate investment partnerships.

Treasury and IRS double down on the position that the term "corporation" in § 1061 does not include S corporations. Under new § 1061(c)(4)(A), an interest in a partnership is not an API if it is held "directly or indirectly ... by a corporation." This exception makes sense in the context of C corporations (which do not qualify for the capital gains preference), but if the exception includes S corporations, Congress created a major loophole in § 1061. In other words, an easy way to avoid new § 1061 would be to form an S corporation to hold a taxpayer's APIs. In Notice 2018-18, 2018-12 I.R.B.

443 (3/19/18), however, Treasury and the IRS announced that regulations under § 1061 "will provide that the term 'corporation' for purposes of section 1061(c)(4)(A) does not include an S corporation." Sure enough, the final regulations provide that an API is subject to new § 1061 if it is held by an "Owner Taxpayer" (the person subject to federal income taxation) or a "Passthrough Entity" (which has the usual meaning, but expressly includes S corporations). *See* Reg. § 1.1061-3(b)(2). The preamble to the final regulations notes that one commentator argued that interpreting the term "corporations" to exclude S corporations "is subject to substantial doubt and contrary to the plain text of the statute." T.D. 9945, Guidance Under Section 1061, 86 F.R. at 5465 (1/19/21). Another commentator suggested that a legislative clarification should be enacted by Congress before Treasury and the IRS take this position. *Id*. Who's right? *Stay tuned. This issue is almost certain to be litigated.*

Who cares? Although it cannot be ignored by partnerships issuing carried (a/k/a profits) interests, the practical effect of new § 1061 appears minimal. The provision likely will catch only those rare taxpayers who either (i) fail to hold their carried interests for more than three years, or (ii) lack the sophisticated advice to plan around the statute. One commentator characterizes the new statute as a "joke" given that most managers of real estate, hedge funds, and investment partnerships hold their carried interests for well over three years. *See* Sloan, *Carried Interest Reform is a Sham*, Washington Post, December 1, 2017.

C. Distributions and Transactions Between the Partnership and Partners

D. Sales of Partnership Interests, Liquidations and Mergers

E. Inside Basis Adjustments

F. Partnership Audit Rules

G. Miscellaneous

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. Multiple exempt organization regulatory projects closed (or "canned?) in 2020 and early 2021. The 2017 Tax Cuts and Jobs Act made significant changes with respect to the taxation of exempt organizations, including one change that since has been retroactively repealed. We summarize below the recent developments with respect to these changes as well as final regulations relating to the reporting requirements of exempt organizations under Code § 6033.

a. "Phubit" parking tax goes the way of the dodo. The 2017 Tax Cuts and Jobs Act, § 13703, added new Code § 512(a)(7) effective as of January 1, 2018. The effect of new Code § 512(a)(7) was to create or increase an organization's unrelated business taxable income by the amount of any expenses paid or incurred by an organization that are disallowed by the changes made to § 274 for qualified transportation fringe benefits (generally, subsidized parking for employees). In short, new Code § 512(a)(7) turned out to be a disaster—in part because for some organizations it worked not just to increase but to create phantom unrelated business income tax (a/k/a "phubit") where none had existed previously. Wisely, perhaps, Congress retroactively repealed Code § 512(a)(7) in 2019 effective as of the date of enactment in 2017. *See* the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title III, § 302 of the 2020 Further Consolidated Appropriations Act. This retroactive repeal not only eliminated the need for guidance, but also engendered refund claims by affected exempt organizations. Those organizations may file an amended Form 990-T to claim refunds. *See also* IR-2020-23 (1/28/20) (guidance for exempt organizations claiming refunds for any amount of "parking lot tax" paid since 2017).

b. Final regulations consolidating, reconciling, and otherwise clarifying the numerous changes to the annual information return requirements of Code § 6033. T.D. 9898, Guidance Under Section 6033 Regarding the Reporting Requirements of Exempt Organizations, 85 F.R. 31959 (5/28/20). Pursuant to Code § 6033, organizations exempt from taxation under § 501(a) generally are required to file annual information returns and make such returns publicly available for inspection. Exceptions to filing exist (e.g., churches), including exceptions to public disclosure of certain items otherwise reportable on these annual information returns. The applicable rules and exceptions thereto have been modified over the past several years, so in 2020 Treasury and IRS finalized regulations reflecting the cumulative changes. For details, see the final regulations. The final regulations are effective on May 28, 2020, and generally apply to returns file on or after January 30, 2020.

c. No more offsetting UBTI from one trade or business with UBTI from another trade or business. T.D. 9933, Unrelated Business Taxable Income Separately Computed for Each Trade or Business, 85 F.R. 77952 (12/2/20). Organizations described in § 401(a) (pension and retirement plans) and § 501(c) (charitable and certain other entities) generally are exempt from federal income taxation. Nevertheless, §§ 511 through 514 impose federal income tax upon the "unrelated business taxable income" ("UBTI") of such organizations, including for this purpose state colleges and universities. The principal sources of UBTI are §§ 512 and 513 "unrelated trade or business" gross income (minus deductions properly attributable thereto) and § 514 "unrelated debt-financed income" (minus deductions), including a partner's allocable share of income from a partnership generating UBTI. Under pre-TCJA law, if an exempt organization had unrelated business income ("UBI") from one activity, but unrelated losses from another activity, then the income and losses could offset, meaning that the organization would report zero or even negative UBI. New § 512(a)(6), effective as of January 1, 2018, provides that income and losses from separate unrelated trades or businesses no longer may be aggregated. The "catch" to new § 512(a)(6), though, is that exactly what constitutes a separate "trade or business" for UBTI purposes has never been defined, and new § 512(a)(6) did not do so either. *See* Notice 2018-67, 2018-36 I.R.B. 409 (8/21/18). In 2020, Treasury and the IRS finalized regulations providing guidance on how exempt organizations segregate trades or businesses for purposes of determining UBI in accordance with § 512(a)(6). Generally, the new regulations, Reg. § 1.512(a)-6, provide that an exempt organization must identify and segregate each of its separate unrelated trades or businesses using the first two digits of the North American Industry Classification System code (NAICS 2-digit code) system. Organizations should do so by choosing the NAICS 2-digit code that most accurately describes the unrelated trade or business. Notably, the regulations do not adopt the approach taken by the § 199A regulations because, in the view of the IRS and Treasury, § 512(a)(6) and § 199A serve different purposes. The regulations are detailed and complex, and will not be discussed further here. They are, however, a must read for tax advisors to exempt organizations that have UBTI. The regulations are applicable to taxable years beginning on or after December 2, 2020. In addition, affected exempt organizations may choose to apply the regulations to taxable years beginning on or after January 1, 2018, and before December 2, 2020. Alternatively, affected exempt organizations may rely on a reasonable, good-faith interpretation of § 512(a)(6) for such taxable years. For this purpose, a reasonable good faith interpretation includes the methods of aggregating or identifying separate trades or businesses provided in Notice 2018-67 or the previously published proposed regulations, REG-106864-18, Unrelated Business Taxable Income Separately Computed for Each Trade or Business, 85 F.R. 23172 (4/24/20).

d. Final guidance from Treasury and IRS admits Congress's "airball" when enacting new Code § 4960. T.D. 9938, Unrelated Business Taxable Income Separately Computed for Each Trade or Business, 86 F.R. 6196 (1/19/21). Another change to the taxation of exempt organizations was the addition of new Code § 4960 by § 13602 of the 2017 Tax Cuts and Jobs Act. Code § 4960 imposes a 21 percent excise tax on "applicable tax-exempt organizations" ("ATEOs") and broadly-defined "related organizations" paying over $1 million annually to "covered employees." In addition to § 527 political organizations and § 521 farmers cooperatives, ATEOs include the following two additional types of organizations: (i) those exempt from tax under § 501(a) (most nonprofits, including churches, hospitals, and private schools); and (ii) those "with income excluded from taxation under § 115(l)" (income of certain public utilities and income derived from "any essential governmental function and accruing to a State or any political subdivision thereof"). A "covered employee" is defined as any one of the five highest compensated employees of an ATEO either (i) for the current taxable year or (ii) for any year beginning after December 31, 2016. Licensed medical or veterinarian professionals, however, are excluded from the definition of "covered employee." Treasury and the IRS issued proposed guidance regarding Code § 4960 in June of 2020, *see* REG-122345-18, Tax on Excess Tax-Exempt Organization Executive Compensation, 85 F.R. 35746 (6/11/20), and finalized the regulations in early January 2021. *See* T.D. 9938, Unrelated Business Taxable Income Separately Computed for Each Trade or Business, 86 F.R. 6196 (1/19/21). These proposed and then final regulations followed interim guidance issued early in 2019. *See* Notice 2019-09, 2019-04 IRB 403 (1/22/19). The regulations are technical and extensive, so they will not be discussed in detail here. Importantly, though, new Code § 4960 essentially does not apply to governmental entities (including state colleges and universities) with highly-compensated executives (e.g., coaches), even though Congress apparently thought that it would. The reason such governmental entities generally escape Code § 4960 is because Congress attempted to describe them as organizations "with income excluded from taxation under § 115(l)." The IRS's longstanding position, however, is that governmental entities (including state colleges and universities) which are not separately incorporated are exempt under the doctrine of implied statutory immunity notwithstanding § 115(l) (unless and until Congress enacts a specific statutory provision, like § 511(a)(2)(B) regarding UBIT, subjecting such state-affiliated organizations to tax). *See* Rev. Rul. 87-2, 1987-1 C.B. 18; Rev. Rul. 71-131, 1971 C.B. 29; Rev. Rul. 71-132, 1971-1 C.B. 29; G.C.M. 14407 (Jan. 28, 1935). *See also* Ellen P. Aprill, *The Integral, the Essential, and the Instrumental: Federal Income Tax Treatment of Government Affiliates*, 23 J. Corp. Law 803 (1997). The preamble to the proposed regulations confirms this important point, stating that a "governmental entity (including a state college or university) that does not have a determination letter recognizing its exemption from taxation under section 501(a) and that does not exclude income from gross income under section 115(1) is not an ATEO." REG-122345-18, Tax on Excess Tax-Exempt Organization Executive Compensation, 85 F.R. 35746 at 35747 (6/11/20). Furthermore, a state college or university that has secured exemption under § 501(a) (because it applied for tax-exempt status thereunder using IRS Form 1023 and received a determination letter) "may relinquish this status pursuant to the procedures described in section 3.01(12) of Rev. Proc. 2020-5 (2020-1 I.R.B. 241, 246) (or the analogous section in any successor revenue procedure)." *Id*. The final regulations are effective as of January 15, 2021, and apply to taxable years beginning after December 31, 2021.

B. Charitable Giving

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. IRS revenue agents really need to learn to obtain the required supervisory approval of penalties <u>before</u> communicating the penalties to taxpayers. Beland v. Commissioner, 156 T.C. No. 5 (3/1/21). The issue in this case was whether the IRS was precluded from asserting penalties because it had failed to comply with the requirement of § 6751(b)(1) that the initial determination of the assessment of a penalty be "personally approved (in writing) by the immediate supervisor of the individual making such determination." The revenue agent auditing the 2011 return of the taxpayers, a married couple, issued an administrative summons to the taxpayers to appear. Pursuant to the summons, the taxpayers met with the revenue agent for a closing conference, which is held during the closing phase of an examination. During the conference, the revenue agent presented Form 4549, Income Tax Examination Changes, commonly referred to as the revenue agent's report, which included a fraud penalty. The taxpayers declined to sign the revenue agent's report or to consent to an extension of the limitations period on assessment. Following the meeting, the revenue agent sent the examination case file and a civil penalty approval form to a General Manager for approval. The General Manager signed the civil penalty approval form. The Tax Court (Judge Greaves) held that the IRS was precluded from asserting the fraud penalty Among other authorities, the court relied on its prior decision in *Belair Woods, LLC v. Commissioner*, 154 T.C. No. 1 (1/6/20), in which the court had held that initial determination of a penalty occurs in the document through which the IRS Examination Division notifies the taxpayer in writing that the examination is complete and it has made a decision to assert penalties. In this case, the court held, the initial determination of the penalty was the revenue agent's report, which was presented to the taxpayers during the closing conference. Because the IRS failed to secure the required supervisory approval before the initial determination of the penalty, § 6751(b)(1) precluded the IRS from asserting the penalty.

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

F. Liens and Collections

1. Coworking might carry some tax risk. A notice of intent to levy sent by certified mail to shared office space and signed for by someone unaffiliated with the taxpayer triggered the 30-day period for requesting a CDP hearing. Ramey v. Commissioner, 156 T.C. No. 1 (1/14/21). On July 13, 2018, the IRS mailed to the taxpayer a notice of intent to levy. The notice of intent to levy informed the taxpayer that he could request a collection due process (CDP) hearing by mailing Form 12153 to the IRS by August 12, 2018. The IRS mailed the notice by certified mail with a return receipt requested. The taxpayer did not challenge the address to which the notice was sent. An individual signed for the notice, but the taxpayer maintained that several businesses used the same address and that the individual who signed was not his employee and was not authorized to receive mail on his behalf. The taxpayer actually received the notice shortly before the August 12 deadline to request a CDP hearing. The taxpayer mailed Form 12153 to the IRS after the August 12 deadline and the IRS Appeals Office therefore treated his submission as untimely and provided an "equivalent hearing" pursuant to Reg. § 301.6330-1(i)(1). Following the hearing, the IRS Appeals Office issued a "Decision Letter on Equivalent Hearing Under Internal Revenue Code Sections 6320 and/or 6330" upholding the proposed collection action. The taxpayer filed a petition in the Tax Court seeking review of the decision letter. The IRS moved to dismiss for lack of subject matter jurisdiction on the ground that it had not issued a notice of determination following a CDP hearing and that a decision letter following an equivalent hearing is not subject to judicial review. The taxpayer responded that the notice of intent to levy mailed by the IRS was invalid because it had not been properly served and had been signed for by a "random person." The Tax Court (Judge Toro) granted the IRS's motion to dismiss. The court reasoned that § 6330(d)(1) grants the Tax Court jurisdiction to review a determination made by IRS Appeals under § 6330, but that the court's jurisdiction is contingent on both the issuance of a valid notice of determination by IRS Appeals and the filing of a timely petition (within 30 days) by the taxpayer. In this case, the court observed, the IRS had not issued a notice of determination. Nevertheless, the court inquired whether the taxpayer had timely requested a CDP hearing by filing Form 12153 because, in prior decisions, the court had concluded that, if the IRS Appeals Office incorrectly concludes that the taxpayer's request for a CDP hearing was untimely and issues a decision letter, the court would treat the decision letter as a notice of determination that confers jurisdiction on the court. *See Craig v. Commissioner*, 119 T.C. 252 (2002); *Andre v. Commissioner*, 127 T.C. 68 (2006). In this case, the court concluded, the taxpayer's request for a CDP hearing was untimely. The court rejected the taxpayer's argument that the notice of levy was deficient because he did not sign for it or receive it in a timely manner and the person who did sign for it had no authority to receive it. The court observed that, under § 6330(a)(2), there are three ways in which the IRS can provide notice of its intent to levy. The third authorized method is for the notice to be "'sent by certified or registered mail, return receipt requested,' to the taxpayer's last known address." According to the court, this method

> focuses on the sending of the notice, not the taxpayer's receipt of it. It describes the type of USPS service the IRS must select-certified or registered mail, return receipt requested. … The primary responsibility of the IRS under this method of service is to place the notice in the hands of the USPS. So long as the IRS properly addresses the notice to the taxpayer's last known address and selects the correct type of service from the USPS … the IRS complies with the terms of the statute.

This conclusion, the court observed, is reflected in the regulations under § 6330, which provide that "[a]ctual receipt is not a prerequisite to the validity of the CDP [n]otice." Reg. § 301.6330-1(a)(3), Q&A 9. Accordingly, the court concluded, the IRS's mailing of the notice of intent to levy started the running of the 30-day period for the taxpayer to request a CDP hearing and the taxpayer's request was untimely. The court noted that the taxpayer was not left without an opportunity to seek judicial review of his tax obligations because he could pay the tax in question, seek a refund, and then bring a refund action in a U.S. District Court or the U.S. Court of Federal Claims.

G. Innocent Spouse

H. Miscellaneous

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION