RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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State Bar of Texas Tax Section
First Wednesday Tax Update
October 2, 2024

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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. Eleventh Circuit affirms Tax Court in denying a deduction for “legal fees” determined to be related to criminal charges arising out of inappropriate personal activities. Anderson v. Commissioner, 133 A.F.T.R. 2d 2024-1551 (10th Cir. 5/17/24), *aff’g*, T.C. Memo. 2023-42 (3/28/23). The taxpayer in this case, a doctor who researched gene therapy, was arrested on allegations of sexually abusing the minor daughter of his research assistant. He was convicted in California state court and sentenced to prison. The IRS disallowed deductions for legal fees on the taxpayers’ (husband’s and wife’s) federal income tax returns for 2013 and 2014 and issued a notice of deficiency for those years. The taxpayers responded by filing a petition in the Tax Court and argued that the legal fees were deductible as ordinary and necessary business expenses under § 162. The Tax Court (Judge Paris) disallowed the taxpayers' legal expense deductions for 2013 ($292,175) and disallowed $65,120 of the $68,120 in deductions for 2014. The Tax Court allowed the taxpayer to deduct $3,000 of the 2014 legal fees (plus an additional $10,000 not previously claimed) because those fees had been paid for an investigation related to his trade or business. On appeal, in an order and judgment by Judge Tymkovich, the U.S. Court of Appeals for the Eleventh Circuit agreed with the Tax Court's analysis. The taxpayers asserted that they had paid the legal fees, at least in part, for an investigation of the doctor's former colleague, who allegedly had filed false accusations of molestation against the doctor in an effort to steal his intellectual property. In both the Tax Court and on appeal, the taxpayers argued that the Tax Court misapplied the Supreme Court's decision in *Commissioner v. Tellier*, 383 U.S. 687 (1966). In *Tellier*, the petitioner was in the securities business and was found guilty of securities fraud. Mr. Tellier sought to deduct his legal fees as a business expense and the IRS disallowed the deduction "on the ground of tax fraud." *Tellier*, 383 U.S., at 690. The IRS conceded in *Tellier* that the legal fees were business expenses but argued that the deductions should be disallowed as a public policy exception to § 162, which authorizes a deduction for ordinary and necessary business expenses. *Id.* The Supreme Court disagreed and held that public policy does not prohibit a deduction of legal fees related to criminal activity so long as the legal fees are an ordinary and necessary expense of the taxpayer's trade or business. *Id.* at 694-95. The Eleventh Circuit in this case distinguished *Tellier* and reasoned that the issue in this case was not whether the taxpayers' deductions were disallowed by public policy, but rather whether legal fees paid by the taxpayers were actual business expenses. Pursuant to the U.S. Supreme Court's decision in *United States v. Gilmore,* 372 U.S. 39, 48-49 (1963), the deductibility of legal fees depends on the origin and character of the claim for which the expenses were incurred and whether the claim has a sufficient connection to the taxpayer's business or income-producing activities. Under *Gilmore*, "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test." *Id.* at 49. Here, the Eleventh Circuit agreed with the Tax Court's reasoning that the taxpayer was charged with sexual abuse of a minor that was alleged to have occurred at the taxpayer's home. Those activities were personal in nature and did not involve or arise out of the taxpayer's gene therapy business. Rather, the expenses the taxpayer attempted to deduct were primarily related to his ineffective assistance of counsel claim in his criminal case and a later proceeding in which he filed a state habeas corpus petition seeking his release from prison. The Eleventh Circuit adopted the Tax Court's reasoning that the criminal charges did not involve the taxpayer's gene therapy business or any other activity for the production or collection of income. The connection between the taxpayer's criminal proceedings and his occupation was merely tangential. Further, any economic loss to the taxpayer's business following the conviction was a collateral consequence of the criminal case and not the origin of the claimed expenses. The court therefore affirmed the Tax Court's disallowance of the majority of the taxpayer's legal expense deductions in 2013 and 2014.

E. <u>Depreciation & Amortization</u>

F. <u>Credits</u>

G. <u>Natural Resources Deductions & Credits</u>

H. <u>Loss Transactions, Bad Debts, and NOLs</u>

I. <u>At-Risk and Passive Activity Losses</u>

III. INVESTMENT GAIN AND INCOME

A. <u>Gains and Losses</u>

1. There's now a statutory income tax cost for low-balling estate tax valuation. The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2004(a), added § 1014(f), which requires that the basis of any property taking a § 1014 date-of-death-value shall not exceed the final value as determined for estate tax purposes, or, if the value of the property has not been finally determined for estate tax purposes, the value stated in a statement (required by new § 6035(a) to be provided by the executor of any estate required to file an estate tax return) identifying the value of the property. Section 1014(f)(2) provides that the consistency rule applies only to property the inclusion of which in the decedent's estate increased the estate tax liability (reduced by allowable credits). Thus, if the total value of the decedent's estate, as correctly determined, is less than the decedent's unified credit exemption, it appears that the consistency requirement does not apply or if the taxable estate is reduced to no more than the exclusion amount by the estate tax marital deduction or the estate tax charitable deduction. Also, an estate tax return filed solely to enable a surviving spouse to claim a deceased spouse's unused unified credit under the portability rules would not invoke the consistency requirement. The basis has been finally determined for estate tax purposes only if (1) the value of the property as shown on the estate tax return was not contested by the IRS before the statute of limitations expired, (2) the value is specified by the IRS on audit and was not timely contested by the executor of the estate, or (3) the value is determined by a court or pursuant to a settlement with the IRS.

- Act § 2004(b) also added Code § 6035. Section 6035(a)(1) and (a)(2) require the executor of any estate required to file an estate tax return to report to the IRS and each beneficiary acquiring any interest in property included in the decedent's gross estate a statement identifying the value of each interest in such property as reported on such return and any other information as the Treasury and IRS may prescribe. Section 6035(a)(3)(A) provides that each statement required to be furnished under § 6035(a)(1) or (a)(2) shall be furnished at such time as the IRS prescribes, but no later than the earlier of (i) 30 days after the due date of the estate tax return (including any extensions) or (ii) 30 days after the date the estate tax return is filed. New Code § 6035(b) directs the Treasury Department to promulgate regulations as necessary to carry out the new provision, including regulations relating to (1) the application of § 6035 to property with regard to which no estate tax return is required to be filed, and (2) situations in which the surviving joint tenant or other recipient may have better information than the executor regarding the basis or fair market value of the property.

- Act § 2004(c) added new Code § 6662(b)(8) to extend the 20 percent accuracy related penalty to "any inconsistent estate basis," which is defined in new § 6662(k) as a basis claimed on an income tax return that exceeds the basis determined under § 1014(f).

- These provisions apply to property with respect to which an estate tax return is filed after 7/31/15. However, in a series of notices, the IRS provided that the statements required by new § 6035(a)(1) and (a)(2) were not due before June 30, 2016. See Notice 2015-57, 2015-36 I.R.B. 294 (8/21/15); Notice 2016-19, 2016-9 I.R.B. 362 (2/11/16); Notice 2016-27, 2016-15 I.R.B. 576 (3/24/16). The IRS later confirmed the extension to June 30, 2016, in final regulations. Reg. § 1.6035-2(a).

- In early 2016, the IRS issued the final version of Form 8971, Information Regarding Beneficiaries Acquiring Property From a Decedent. An executor required to file Form 8971 must send Schedule A of the Form to each beneficiary receiving property included on the estate tax return. At the time the estate tax return is filed, the estate may not have made distributions and may not have identified the specific property that a beneficiary will receive. To account for this situation, the instructions to Form 8971 indicate that the Schedule A issued to a beneficiary should report "all items of property that could be used, in whole or in part, to fund the beneficiary's distribution on that beneficiary's Schedule A." When the estate later distributes property to the beneficiary, the executor must file a supplemental Form 8971 and issue a corresponding Schedule A.

a. The IRS issues final regulations. T.D. 9991, Consistent Basis Reporting Between Estate and Person Acquiring Property from Decedent, 89 F.R. 76356 (9/17/24). Treasury and the IRS have finalized proposed regulations regarding (1) the requirement of § 1014(f) that a recipient's basis in certain property acquired from a decedent be consistent with the value of the property as finally determined for federal estate tax purposes, and (2) the reporting requirements of § 6035 for executors or other persons required to file federal estate tax returns. The regulations clearly state that if, after taking into account all available credits other than the credit for prepayment of tax, no estate tax is payable, no property is subject to the basis consistency requirements. Reg. § 1.1014-10(c)(1)(ii). *See also* Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 2015, 27 (JCS-1-16, March 2016). However, for a taxable estate, the basis consistency rules do not apply to certain categories of property, including (1) property qualifying for the estate tax charitable or marital deductions, and (2) household and personal effects for which an appraisal is not required under Reg. § 20.2031-6(b), which requires an appraisal for "household and personal effects articles having marked artistic or intrinsic value of a total value in excess of $3,000." Reg. § 1.1014-10(c)(2). Until the final value of property subject to the consistency rule has been determined, the recipient may use as his unadjusted basis the amount reported to him by the executor, Reg. § 1.1014-10(b)(2) (the amount reported on Form 8971 as required by § 6035), but if final value is later determined to be different, the beneficiary may be subject to deficiency procedures. The proposed regulations provided that "after discovered or omitted property" not reported on the initial estate tax return or a supplemental return prior to the expiration of the assessment period would have a zero basis, as well as all property in an estate if no estate tax return had been filed by an estate that was required to file, until either a return was filed or a final value was determined by the IRS. Prop. Reg. § 1.1014-10(c)(3). The final regulations omit this "zero basis" rule and instead provide that the consistent basis requirement applies to "included property," defined in Reg. § 1.1014-10(d)(4) as property whose value is reported on an estate tax return or otherwise is included in the total value of the gross estate. The effect of this change is that the basis of property acquired or passed from a decedent that is not reported on an estate tax return and not otherwise included in the gross estate generally is determined under § 1014(a), without regard to the rules of § 1014(f).

Reg. § 1.6035-1 provides very detailed guidance—far more detailed than is noted here—regarding the procedures under new § 6035 requiring the executor of any estate required to file an estate tax return to furnish to the IRS and to each beneficiary acquiring any interest in property included in the gross estate a statement identifying the value of each interest in such property as reported on such return and any other information that the IRS may prescribe. The reporting requirement does not apply if a return is not required to be filed, but was filed for the purpose of making a generation skipping tax allocation, a portability election, or any protective filing to avoid penalties if value is later determined to cause a return to be required. Reg. § 1.6035-1(b)(1). An executor must file a supplemental statement when "a change [occurs] to the information required to be reported on the Information Return or Statement… [that] causes the information as reported to be incorrect or incomplete." Reg. § 1.6035-1(d)(1). The regulations make it clear that § 6035 applies more broadly than the basis consistency rule of § 1014(f), which applies only to that property included in the gross estate that causes an increase in federal estate tax liability; § 6035 requires reporting of "the value of property included on a required Federal estate tax return," which includes, for example, an estate that is not taxable due to martial or charitable deductions that reduce the amount of tax otherwise due to less than the allowable unified credit.

Section 1.1014-10 of the final regulations applies to property described in Reg. § 1.1014-10(c)(1) of the final regulations that is acquired from a decedent or by reason of the death of a decedent if the decedent's estate tax return is filed after the date of publication of the final regulations in the Federal Register. Section §1.6035-1(j) of the regulations provides that Reg. § 1.6035-1 of the final regulations applies to executors of a decedent's estate who are required to file an estate tax return under section 6018 if that return is filed after the date of publication of these final regulations in the Federal Register, and to trustees receiving certain property included in the gross estate of such a decedent.

B. Interest, Dividends, and Other Current Income

C. Profit-Seeking Individual Deductions

D. Section 121

E. Section 1031

F. Section 1033

G. Section 1035

H. Miscellaneous

IV. COMPENSATION ISSUES

V. PERSONAL INCOME AND DEDUCTIONS

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

C. Liquidations

D. S Corporations

E. Mergers, Acquisitions and Reorganizations

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

1. Much ado about nothing . . . or an open can of worms full of you know what flung against a fan?!?! A U.S. corporation with a tax year straddling the effective date of the TCJA was entitled to a deduction under § 245A for a deemed dividend from a CFC the U.S. corporation was required to include in income under § 78. Varian Medical Systems Inc. v. Commissioner, 163 T.C. No. 4 (8/26/24). Candidly, we are not sure if this reviewed case of first impression from the Tax Court is a yawner or a gobsmacker. Only time will tell. The taxpayer took advantage of *both* § 78 *and* § 245A for its 2018 tax year due to conflicting effective date language in the 2017 Tax Cuts and Jobs Act (TCJA). Except in circumstances almost identical to this case (where a multinational corporate taxpayer's taxable year straddles the enactment of the TCJA), taking advantage of both § 78 and § 245A is expressly prohibited. *See* IRC § 78. *Yes, we told you the case has extremely narrow application, but that's not really the important part, so keep reading.* The Tax Court's precedential opinion does not entirely settle the case, but it does resolve competing cross-motions for summary judgment filed by the taxpayer and the IRS.

Broader implications of the case. On one hand, the Tax Court addressed an unusually narrow set of facts, largely ruling in favor of a clever multinational corporate taxpayer who for *one taxable year* took advantage of a known, limited-time loophole: a mismatch in the TCJA's effective date provisions concerning § 78 and § 245A. On the other hand, the Tax Court reached its decision by completely disregarding a Treasury regulation that purported to close the loophole. The Treasury regulation sought to close the loophole retroactively as had been proposed in technical corrections legislation that our dysfunctional Congress drafted but never passed. The authors believe that the Tax Court, as explained in a well-written opinion by Judge Toro, reached the correct result, especially considering the straightforward but conflicting effective date language in the relevant statutes. Nevertheless, the real significance of the case is the Tax Court's willingness to completely disregard the loophole-closing Treasury regulation on point. Going forward, it seems clear that the Tax Court (and other federal courts as well) will exercise independent judgment when evaluating government agency interpretations of statutes. Thus, the Tax Court no longer will defer to Treasury's admittedly self-interested interpretation of ambiguous, or arguably ambiguous, Code provisions. Instead, interpretative (as opposed to legislative) Treasury regulations and other administrative guidance not satisfying the new *Loper Bright* "best interpretation" standard adopted by the U.S. Supreme Court may be disregarded or invalidated. We elaborate below.

Factual Background. The taxpayer was the parent company of a consolidated group of medical device and software manufacturers headquartered in the U.S. The taxpayer also operated internationally, including through controlled foreign corporation ("CFC") subsidiaries within the meaning of subpart F of the Code. *See* IRC § 957.[1] The taxpayer and its CFC subsidiaries previously had adopted a fiscal (as opposed to a calendar) taxable year for federal income tax purposes. The taxpayer's fiscal taxable year in this case ran from September 30, 2017, through September 28, 2018 (the "2018 tax year"). The TCJA was enacted late in 2017. Thus, the taxpayer's 2018 tax year straddled the enactment of the TCJA. Reading between the lines, we believe that for its 2018 tax year the taxpayer was subject to the § 965 "Mandatory Repatriation Tax" ("MRT") enacted by the TCJA as part of Congress's overhaul of subpart F of the Code.[2] Accordingly, the taxpayer was keen to ameliorate the adverse impact of the MRT. Regardless, the taxpayer's international operations via its CFC subsidiaries for its 2018 tax year permitted the taxpayer to claim approximately $161 million in § 901 foreign tax credits. Those claimed foreign tax credits in turn implicated § 78 (deemed dividends relating to claimed foreign tax credits) and § 245A (deduction relating to dividends received from specified 10-percent owned foreign corporations).

Legal Background. As noted above, § 245A was enacted at the end of 2017 as part of the TCJA's extensive revisions to subpart F of the Code. Generally, § 245A grants a dividends-received deduction ("DRD") to a domestic corporation that is a United States shareholder with respect to any "specified 10-percent owned foreign corporation" for any dividend received from the foreign corporation. *See* § 245A(a). Importantly, § 245A became effective for "distributions made after December 31, 2017." Thus, § 245A applied to any dividends received by the taxpayer from its CFC subsidiaries on or after January 1, 2018. The dividends-received deduction authorized by § 245A eliminates U.S. taxation of distributions (or deemed distributions) of untaxed foreign-source income. Contrastingly, § 78 has been a part of the Code since 1962. Section 78 was enacted to achieve tax parity between U.S. corporations operating internationally through foreign branches vis-a-vis those operating through CFCs. Section 78 achieves this tax parity by "grossing up" a U.S. corporate CFC shareholder's dividends received by the amount of foreign taxes

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[1] Under § 957(a), a CFC generally is a non-U.S. corporation if, on any day during the corporation's taxable year, "United States shareholders" own stock possessing more than 50 percent of either the total voting power of all classes of stock entitled to vote or the total value of the corporation's stock. Pursuant to § 957(b), a "United States shareholder" is a "United States person" (see § 7701(a)(30)) who owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote (before 2018) or 10 percent or more of the total value of shares of all classes of stock of the foreign corporation (after 2017).

[2] We previously summarized the MRT in connection with our discussion of SCOTUS's decision in Moore v. United States, 602 U.S. ___ (6/20/2024). The MRT imposes "a one-time pass-through tax" that is "backward-looking" on the accumulated but undistributed income of "American-controlled foreign corporations." *Moore*, 144 S. Ct. at 1686. Put differently, the MRT effectuates a deemed repatriation (in corporate tax parlance, "deemed dividend") of earnings and profits to U.S. shareholders holding 10 percent or more of the controlled foreign corporation's stock. Longstanding provisions of subpart F have operated the same way for decades, but before the TCJA-enacted MRT, subpart F mainly applied to passive income. The MRT was enacted in 2017 to correct a perceived abuse by taxing U.S. shareholders on their share of post-1986 accumulated but undistributed trade or business income of "controlled foreign corporations" (as defined) even though a dividend had not been declared. Otherwise, if the income earned by the foreign corporation was never repatriated, it remained indefinitely untaxed by the U.S. The MRT also operates prospectively after 2017 with respect to "global intangible low-taxed income" (a/k/a "GILTI") *See* IRC § 951A.

imposed on the foreign earnings and deemed paid and claimed by the U.S. corporate shareholder as a foreign tax credit under § 960. For example, if the U.S. corporate shareholder receives a dividend of $70 from a CFC and the CFC has paid $30 in foreign taxes for which the U.S. corporate shareholder claims a foreign tax credit under § 960, then, under § 78, the U.S. corporate shareholder would be treated as receiving a dividend of $100 ($70 + $30) and would claim a foreign tax credit of $30 against the corporation's U.S. tax liability.[3] In this example, § 78 treats the $30 of foreign tax deemed paid as a dividend received by the U.S. corporate shareholder. This gross-up of the dividend is designed to prevent the U.S. corporate shareholder from effectively obtaining both a deduction and a credit for foreign tax deemed paid. The deemed dividend under § 78, however, has never been eligible for the normal § 245 DRD and, except as applied in this case, was not supposed to be eligible for the § 245A DRD. (The normal § 245 DRD was not relevant to this case.) Specifically, before the TCJA, § 78 stated that the foreign taxes deemed paid by the U.S. corporate shareholder "shall be treated for purposes of this title (*other than section 245*) as a dividend received by such domestic corporation from the foreign corporation." *See* IRC § 78 (2016) (emphasis added). Therefore, in connection with enacting new § 245A, the TCJA amended the above-quoted parenthetical in § 78 to add a cross-reference to § 245A as follows: "(other than sections 245 *and 245A*)." *See* § 78 (2024) (emphasis added). Nonetheless amended § 78's effective date provision under the TCJA — and here's the big "*Oops*" at the crux of the case — states that the revised statute applies for "taxable years of foreign corporations beginning after December 31, 2017, and . . . taxable years of United States shareholders in which or with which such taxable years of foreign corporations end." TCJA § 14301(d), 131 Stat. at 2225. As noted above, then, § 245A applies to "distributions made after December 31, 2017." Thus, as Judge Toro put it in the Tax Court's opinion, the TCJA's mismatched effective date language left a narrow "gap" during which both § 78 and § 245A theoretically could apply to taxpayers with a fiscal year straddling the enactment of TCJA. 163 T.C. at ___. As a result, a U.S. corporation exploiting this gap could claim a foreign tax credit for foreign taxes actually paid by the foreign corporation paying the dividend (and deemed paid by the U.S. corporation receiving the dividend) and simultaneously deduct the dividend received, i.e., the U.S. corporation effectively receives both a tax-free dividend and a foreign tax credit.

Treasury's Attempted "Gap" Fix. Treasury, the IRS, and Congress were well aware of this unintended "gap" in the TCJA's mismatched effective date language concerning §§ 78 and 245A. On January 2, 2019, the House Ways and Means Committee published a *Tax Technical and Clerical Corrections Act Discussion Draft* that would have retroactively closed the "gap" as of the enactment of the TCJA. The proposed fix, however, was never passed by Congress. Regardless, Treasury published on June 21, 2019, a revised, interpretative regulation under § 78 that disallowed the § 245A deduction for the deemed dividend engineered by § 78. The revised regulation under § 78 purported to be retroactively effective to § 78 deemed dividends occurring on or after January 1, 2018, despite the contrary effective date language (as quoted above) in the TCJA regarding amended § 78. *See* Reg. 1.78-1 (stating in part and emphasis added: "A section 78 dividend is treated as a dividend for all purposes of the Code, except that it is not treated as a dividend for purposes of sections 245 *or 245A* . . . .").

The Arguments. Because the case has such narrow applicability regarding potentially affected taxpayers, we have minimized our discussion of the taxpayer's and the IRS's arguments regarding whether §§ 78 and 245A could apply to the taxpayer's 2018 fiscal tax year. Essentially, the

[3] Stating the obvious, perhaps, we have greatly oversimplified the tax analysis pertaining to foreign tax credits and subpart F of the Code, including the deemed dividend, increase to taxable income, the § 245A DRD, and the tax parity achieved by § 78. Judge Toro's opinion, however, provides a helpful but also somewhat simplified illustration at 163 T.C. ___ -___. We commend it to readers curious about the interrelationship between subpart F, foreign tax credits, § 78, and § 245A.

taxpayer relied on the plain language of the statutes, including the TCJA effective date provisions, while the IRS was left to make the following unsuccessful "should be" arguments:

- § 245A should be read to apply, even for the "gap" period, only to dividends *actually* received rather than deemed § 78 dividends;
- § 275(a)(4) (disallowing a deduction for foreign or territorial taxes for which tax credits are claimed) and § 261 (referencing Code §§ 262 through 280H, which consist of a long list of prohibited deductions for specified items such as personal expenses, capital expenditures, entertainment expenses, etc.) should be read broadly (*somehow?*) to disallow the taxpayer's § 245A DRD for the "gap" period; and
- allowing a DRD under § 245A for a § 78 deemed dividend only within the "gap" period should be considered absurd and contrary to congressional policy and intent.

None of the foregoing arguments were found persuasive by the Tax Court. If you are incurably curious and must understand why the Tax Court rejected the above IRS arguments, read Judge Toro's opinion.

Here's the "Beef"—Impact of Loper Bright on Treasury Regulations. Finally, the IRS argued that Reg. § 1.78-1 (as cited and quoted above) closed the effective date "gap" retroactive to January 1, 2018. Judge Toro wrote in response to this argument:

> The rule adopted by the revised regulations essentially gives one of the TCJA's amendments to section 78 an earlier effective date than provided for in the TCJA to prevent taxpayers like Varian from deducting section 78 dividends. But, as we have already observed, the plain text of the statutes provides for the deduction. As the Supreme Court has said, "self-serving regulations never 'justify departing from the statute's clear text.'"

163 T.C. at ___. The IRS argued in response that its interpretation of §§ 78 and 245A, as reflected in Reg. § 1.78-1, nevertheless should be considered "permissible" and entitled to deference. 163 T.C. at ___. Judge Toro disagreed, though, based upon the U.S. Supreme Court's recent *Loper Bright* decision overturning so-called "*Chevron* deference" previously granted by the courts to administrative interpretations of statutes and promulgation of interpretative regulations. *See Loper Bright Enterprises v. Raimonda*, 603 U.S. ___ (2024), *overruling in part Chevron, U.S.A., Inc. v. Natural Resources Council, Inc.*, 467 U.S. 837 (1984). Instead, Judge Toro flatly refused to apply Reg. § 1.78-1 to close the "gap" against the taxpayer in this case, concluding:

> As the Supreme Court observed in *Loper Bright*, "statutes, no matter how impenetrable, do—in fact, must—have a single, best meaning. That is the whole point of having written statutes; 'every statute's meaning is fixed at the time of enactment.' And, in cases involving ambiguity, "instead of declaring a particular party's reading 'permissible' . . . , courts [must] use every tool at their disposal to determine the best reading of the statute and resolve the ambiguity." Put another way, "in an agency case as in any other . . . even if some judges might (or might not) consider the statute ambiguous, there is a best reading all the same—the reading the court would have reached if no agency were involved."
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> In short, "[i]n the business of statutory interpretation, if it is not the best, it is not permissible." And, as we have shown above, the best (indeed the unambiguous) reading of the provisions at issue here permits [the taxpayer's] deduction.

163 T.C. at ___.

The IRS's Consolation Prize. Although the Tax Court rejected the IRS's arguments that § 245A should not apply to a § 78 deemed dividend arising within the "gap" period created by the TCJA's relevant effective date provisions, the Tax Court did embrace the IRS's argument relating to the determination of the taxpayer's allowed foreign tax credits. As mentioned above, the taxpayer claimed roughly $161 million in foreign tax credits for its 2018 tax year. The IRS's position was that, if the Tax Court determined the taxpayer could take the § 245A DRD attributable to the § 78 deemed dividend for its 2018 tax year, then the taxpayer's claimed foreign tax credits must be reduced under § 245A(d)(1). Section 245A(d)(1) provides: "No credit shall be allowed under section 901 [(foreign taxes)] for any taxes paid or accrued (or treated as paid or accrued) with respect to any dividend for which a deduction is allowed under this section." The taxpayer contended that § 245A(d)(1) was not relevant to a § 78 deemed dividend but was only meant to apply to foreign taxes paid *on* a dividend (whether actual or deemed). The taxpayer paid $0 foreign taxes "on" its § 78 deemed dividend for 2018. Judge Toro, however, was not persuaded by the taxpayer's argument. Instead, Judge Toro adopted the IRS's position that the phrase "with respect to" in § 245A(d)(1) should be read broadly to mean "concerning" or "related to," not simply "on." Therefore, because the taxpayer's § 78 deemed dividend unquestionably relates to the foreign tax credits claimed by the taxpayer, the § 245A(d)(1) limitation applies. Further, because the amount of the § 78 deemed dividend "represents the share of a foreign corporation's earnings that were paid out to a foreign country as tax," Judge Toro likewise adopted the IRS's proposed formula for calculating the § 245A(d)(1) disallowance of a portion of the taxpayer's otherwise allowable foreign tax credits for its 2018 tax year. The formula considers the taxpayer's § 78 deemed dividend and the taxpayer's § 965 subpart F income to reduce the taxpayers claimed § 901 foreign tax credits for its "gap"-controlled 2018 taxable year as follows:

$$\begin{array}{c}\textit{Disallowed}\\ \textit{Foreign}\\ \textit{Tax Credit}\end{array} = \begin{array}{c}\textit{Deemed}\\ \textit{Paid}\\ \textit{Foreign}\\ \textit{Tax}\\ \textit{Credit}\end{array} \times \left(\frac{\textit{Section 78 gross-up}}{\textit{Net section 965 inclusion} + \textit{section 78 gross-up}}\right)$$

The same analysis would apply if a U.S. corporation included in income its share of subpart F income of a CFC under the general subpart F inclusion rule of § 951(a) rather than an amount calculated pursuant to the MRT of § 965.

Comment: Kudos if you have read the foregoing summary and fully appreciate the somewhat disguised significance of the Tax Court's recent decision in *Varian Medical Systems*. Query whether we will begin referring to the "*Varian* test" for Treasury regulations or the "*Varian* formula" where § 245A(d)(1) applies to "gap"-controlled taxable years of multinational corporate taxpayers. One author guesses that the *Varian* formula or some variation thereof will appear in future Treasury regulations interpreting § 245A(d)(1). Of course, the opportunity to apply § 245A, including subsection (d)(1), in the context of a § 78 deemed dividend is limited (at least according to the Tax Court) to those multinational U.S. corporate taxpayers with CFC subsidiaries claiming foreign tax credits within a fiscal taxable year that straddled the enactment of the TCJA. In any event, we strongly suspect other taxpayers will be emboldened by the Tax Court's pronouncement in *Varian Medical Systems* that interpretive (as opposed to legislative) Treasury regulations must satisfy the new *Loper Bright* "best interpretation" standard adopted by SCOTUS. *Let the games (a/k/a litigation) begin . . . .*

- The authors understand that other corporations with tax years that straddle the effective date of the TCJA are now examining their eligibility to deduct under § 245A the deemed dividend required by § 78. For example, the Tax Court recently entered an order granting the motion for partial summary judgment filed by Sysco Corporation on the basis that the court's opinion in *Varian Medical* fully resolved Sysco's eligibility for a deduction under § 245A for the deemed dividend required by § 78. *Sysco Corporation v. Commissioner*, No. 5728-23 (9/13/24).

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>

1. Channeling one-hit-wonder Meghan Trainor, Treasury and IRS sing ♪♫"I'm all about that bas[is], no treble"♫♪ -- especially for "overlooked" partnerships and partners "exploiting" inside/outside basis adjustments (a/k/a "tax technology"???). To understand the recent developments discussed immediately below, some deeper background is necessary regarding basis adjustments allowed by subchapter K. Normally under subchapter K, the aggregate basis of the partners of a partnership in their partnership interests ("outside basis") equals the partnership's aggregate basis in the assets held inside the partnership ("inside basis"). This typical inside/outside basis equilibrium is one of the hallmarks of "flow-through taxation" reflected in subchapter K. Knowledgeable readers know, though, that even if a partnership's aggregate outside basis equals aggregate inside basis, a partnership may have certain assets with a high basis relative to their fair market value and other assets with a low basis relative to their fair market value. Generally, such assets can be distributed in-kind to partners without the partnership or the partners recognizing gain or loss. *See* § 731. Carefully planning and targeting such in-kind distributions to partners with a relatively high or low outside basis compared to the asset's fair market value can have federal income tax advantages. These advantages include increased cost recovery deductions or, upon disposition of an asset, reduced sale or exchange gain or increased sale or exchange loss. Further, under certain circumstances, the usual partnership inside/outside basis equilibrium does not hold true. For example, the death of a partner and the resulting basis step-up in the decedent's partnership interest under § 1014(a)(1) often creates an inside/outside basis disparity. A transfer of an interest in a partnership also can result in an inside/outside basis disparity—because the buyer of a partnership interest obtains a cost basis, but (absent an election under § 754) the transfer does not alter the partnership's inside basis in its assets. *See* § 743. Moreover, a current or liquidating in-kind distribution of partnership property may result in an inside/outside basis disparity under § 732(a), (b), or (c). Inside/outside basis disparities created upon partner contributions of property to partnerships (including upon formation) are somewhat rare, but nevertheless possible. *See* §§ 731(a); 732(a), (b), (d); 733; 734; 743. An optional election under § 754 (adjustment to basis of partnership property), coupled with the application of § 755 (rules for allocation of basis), can rectify these inside/outside basis disparities when it is beneficial from a federal income tax standpoint to do so. The inside/outside basis disparities are (*imperfectly?*) rectified via adjustments to the basis of distributed property, partnership property, or both. *See* §§ 734(b); 743(b); 754; 755. Of course, clever taxpayers, especially related parties, tax-indifferent parties, or parties with a common economic interest, can obtain significant federal income tax advantages (such as increased cost recovery deductions, reduced gain, or increased loss) by manipulating the inside/outside basis adjustment rules of subchapter K. For instance, an in-kind distribution of partnership property to a partner by a partnership with a § 754 election in effect, or with respect to which there is a "substantial basis reduction" (as described in § 734(d)), may result in an adjustment to the basis of the partnership's remaining property under § 734(b). A transfer of a partnership interest in a sale or exchange (or upon the death of a partner) where a § 754 election is in effect, or with respect to which there is a "substantial built-in loss" (as described in § 743(d)(1)), may result in an adjustment to the basis of partnership property under § 743(b) with respect to the transferee partner. These longstanding basis adjustment rules under subchapter K are well-accepted (albeit complicated), but at least according to Treasury and the IRS, are subject to abuse, especially where taxpayer-partners are not bargaining at arm's length.

a. Treasury and IRS plan to audit more partnerships and challenge "basis-shifting" transactions. IRS News Release 2024-166 (6/17/2024); IRS Fact Sheet 2024-21

(6/17/24); Notice 2024-54, 2024-28 I.R.B. 24 (6/17/24); Rev. Rul. 2024-14, 2024-28 I.R.B. 18 (6/17/24); REG-124593-23, Certain Partnership Related-Party Basis Adjustment Transactions as Transactions of Interest, 89 F.R. 51476 (6/17/24). Apparently, Treasury and the IRS have been hard at work understanding and combatting "carefully structured" partnership transactions that "exploit the [above-described] mechanical basis-adjustment provisions of subchapter K to produce significant tax benefits." *See* Notice 2024-54, § 3.04. According to the IRS, "these transactions may employ several steps over a period of years and use sophisticated tax technology to ensure that little or no tax is paid while large amounts of tax basis is 'stripped' from certain assets and shifted to other assets to generate tax benefits," thereby allowing "increased depreciation deductions or reduced gain on the sale of an asset with little or no substantive economic consequence." *See* IRS Fact Sheet 2024-21 cited above. In connection with issuing the new guidance, IRS Commissioner Werfel stated: "This announcement signals the IRS is accelerating our work in the partnership arena, which has been overlooked for more than a decade and allowed tax abuse to go on for far too long. We are building teams and adding expertise inside the agency so we can reverse long-term compliance declines that have allowed high-income taxpayers and corporations to hide behind complexity to avoid paying taxes. Billions are at stake here." *See* IRS News Release 2024-166 cited above. The new guidance issued by Treasury and the IRS, with more coming soon in the form of proposed regulations, is summarized below. Tax advisors also should be aware of a new Form 7217, Partner's Report of Property Distributed by a Partnership, released by the IRS on August 28, 2024, as a draft for public comment.

b. Soon-to-be-issued proposed regulations regarding (i) related-party basis adjustments under subchapter K and (ii) basis-shifting among partner-members of a consolidated group. Notice 2024-54, 2024-28 I.R.B. 24 (6/17/24). This notice announces that Treasury and the IRS intend to publish two sets of proposed regulations addressing certain "basis-shifting" transactions concerning partnerships and related parties. The arrangements targeted by Notice 2024-54 ("covered transactions") involve increases to the basis of property by partnerships and partners under §§ 732 (basis of distributed property other than money), 734(b) (adjustment to basis of undistributed partnership property), or 743(b) (special basis adjustments relating to transfers of partnership interests). The first set of regulations ("Related-Party Basis Adjustments" or "RPBA"), to be issued under the authority of §§ 482, 732, 734(b), 743(b), 755, and 7805, will create special rules concerning cost recovery deductions attributable to "covered transactions." The RPBA regulations will implement mechanical rules applicable to all "covered transactions" without regard to the taxpayer's intent or whether the transactions could be considered abusive or lacking in economic substance. (See the further discussion below regarding Rev. Rul. 2024-14 and the application of the economic substance doctrine.) The second set of regulations, to be issued under the authority of the consolidated return provisions of §§ 1501 and 1502, will apply a "single-entity approach" to interests in a partnership held by members of a consolidated group. This "single-entity approach" will be designed to prevent direct or indirect basis shifts from "covered transactions" among the partner members of the consolidated group. The to-be-published proposed regulations previewed in Notice 2024-54 potentially could have retroactive effect, applying to taxable years ending on or after June 17, 2024. Further, Notice 2024-54 states that the regulations, once finalized, will "govern the availability and amount of cost recovery deductions and gain or loss calculations for taxable years ending on or after June 17, 2024, even if the relevant 'covered transaction' was completed in a prior year. The potential retroactive effect of the proposed regulations previewed by Notice 2024-54 has engendered strong objections from some commentators. For further analysis of Notice 2024-54, see New York State Bar Association Tax Section, Report on Proposed Regulations Regarding Partnership Basis Adjustments and Application of Notice 2024-54 to Previously Effected Transactions, Report #1498 (Aug. 16, 2024).

Alright, you got our attention, but exactly what types of partnership transactions are under the microscope? The partnership "covered transactions" Treasury and the IRS have identified as abusive or potentially abusive generally fall into one of three (or four, depending upon how you cut it) categories. The following descriptions and examples are taken from the recently-issued guidance cited above, especially IRS Fact Sheet 2024-21, Notice 2024-54, and the preamble to REG-124593-23, Certain Partnership Related-Party Basis Adjustment Transactions as Transactions of Interest. The basis adjustment illustrated in each example below is equal to or greater than $5 million because, as discussed further below, $5 million is the reporting threshold for Prop. Reg. § 1.6011-18 regarding "transactions of interest." The proposed regulations previewed by Notice 2024-54, however, presumably will not include any type of minimum basis adjustment threshold before applying special rules concerning cost recovery deductions to partnerships and partners engaging in "covered transactions." Certain partners described in the examples below are related within the meaning of §§ 267(b) (without regard to the attribution rules of § 267(c)(3)) or § 707(b)(1). In general, related parties for this purpose include the following: members of a person's family (siblings, spouse, ancestors, lineal descendants); certain trust grantors, fiduciaries, and beneficiaries; certain estates, executors, and beneficiaries; and more-than-50-percent-controlled corporations and partnerships.

(1) *Transfer of partnership interest to a related party*: A partner with a low share of the partnership's inside basis but a high outside basis transfers the partner's interest in a nonrecognition transaction (as defined in § 7701(a)(45), but including a sale for no gain or loss) to a related person or to a person who is related to other partners in the partnership. The transfer to the related party (along with a § 754 election) generates a special basis increase under § 743(b) to the transferee partner's share of the partnership's inside basis, thereby benefitting the transferee partner via increased cost recovery deductions, reduced gain, or increased losses.

- *Example 4 in the preamble to REG-124593-23*: AB Partnership is owned by partners A and B. A owns 95 percent of the capital and profits interests in AB Partnership and is allocated 95 percent of all losses. B owns 5 percent of the capital and profits interests in AB Partnership and is allocated 5 percent of all losses. A's outside basis is $6 million and share of inside basis is $1 million. AB Partnership owns depreciable property it uses in a trade or business. In a taxable year in which AB Partnership has a section 754 election in effect, A transfers its entire partnership interest to C, a person related to A within the meaning of proposed § 1.6011-18(b)(8) and (b)(9)(ii), in a nonrecognition transaction in which no gain was recognized. Because AB Partnership has a section 754 election in effect for the taxable year of the transfer, under section 743(b)(1), AB Partnership increases the basis of the partnership property with respect to C by $5 million. Assume that under sections 743(c) and 755 and the regulations thereunder, the basis increase with respect to C of $5 million is allocated to partnership property that is depreciable. As a result, C may be allocated depreciation deductions over the recovery periods of the partnership properties equal to the amount of the basis increase under section 743(b)(1).

(2) *Basis "stripping" current distribution of property to a related party*: A partnership with related partners makes a current distribution of a high inside basis asset to a related-party partner who has a low outside basis. The distributee partner takes a low substituted basis in the asset under § 732(a), allowing the partnership (with a § 754 election in effect) to increase the basis of its remaining assets by the "stripped" excess high basis of the distributed asset over the distributee partner's low outside basis. The basis increase to the partnership's remaining assets results in higher depreciation deductions, reduced gain, or increased loss benefitting the related party partners.

- *Example 1 in the preamble to REG-124593-23*: XY Partnership is owned by partners X and Y. The partners are related to each other within the meaning of proposed § 1.6011-18(b)(8) and (b)(9)(i). Each partner directly owns 50 percent of the capital and profits interests in XY Partnership and shares losses equally. X has an outside basis of $10 million, and Y has an outside basis of $1 million. XY Partnership owns property it uses in its trade or business, including Property 1 and Property 2. For Federal income tax purposes, Property 1 is depreciable property and Property 2 is nondepreciable property. XY Partnership has an adjusted basis in Property 1 of zero, and an adjusted basis in Property 2 of $10 million. XY Partnership has a section 754 election in effect for the taxable year and makes a current distribution of Property 2 to Y. Under section 732(a)(2), Y's basis in distributed Property 2 is limited to Y's adjusted basis in its partnership interest of $1 million. As a result of the distribution to Y, Property 2's adjusted basis is decreased from $10 million immediately before the distribution to $1 million in Y's hands. Under section 734(b), XY Partnership must increase the basis of its remaining property. The amount of the basis increase is equal to the excess of XY Partnership's basis in Property 2 immediately before the distribution of $10 million over Y's adjusted basis in Property 2 after the distribution of $1 million, which results in an increase to the basis of XY Partnership's remaining property of $9 million. Under sections 734(c) and 755 and the regulations thereunder, XY Partnership allocates the basis increase of $9 million to Property 1. As a result, XY Partnership claims depreciation deductions based on an increased basis in Property 1.

(3) *Basis boost via liquidation of or current distribution to a related partner*: A partnership with related partners makes a liquidating or current distribution to a particular partner. The partnership distributes a low inside basis asset that was subject to accelerated cost recovery to a partner with a high outside basis, after which the distributee partner increases his/her/its basis in the asset under § 732(b) or makes the election authorized by § 732(d) and secures increased cost recovery deductions or sells the asset for little or no gain.

- *Example 2 in the preamble to REG-124593-23*: DEF Partnership is owned by partners D, E and F. The partners are related to each other within the meaning of proposed § 1.6011-18(b)(8) and (b)(9)(i). D's outside basis is $7 million. E and F each have an outside basis of $1 million. DEF Partnership owns only two properties, Property 1 and Property 2, both of which it uses in its trade or business. For Federal income tax purposes, Property 1 is depreciable property and Property 2 is nondepreciable property. DEF Partnership has an adjusted basis in Property 1 of zero, and an adjusted basis in Property 2 is $9 million. DEF Partnership distributes Property 1 to D in liquidation of D's partnership interest. Under section 732(b), D's basis in distributed Property 1 is equal to $7 million. As a result, D claims depreciation deductions based on a $7 million basis in Property 1.

- *Example 3 in the preamble to REG-124593-23*: XYZ Partnership is owned by partners X, Y and Z. The partners are related to each other within the meaning of proposed §1.6011-18(b)(8) and (b)(9)(i). Each partner directly owns one-third of the capital and profits interests in XYZ Partnership and shares losses equally. XYZ Partnership owns Property 1, Property 2, and Property 3. Property 1 is depreciable property, and XYZ Partnership's adjusted basis in Property 1 is zero. Property 2 and Property 3 are nondepreciable property. X acquired its interest in XYZ Partnership in a nonrecognition transaction from a person related to X within the meaning of proposed §1.6011-18(b)(8). At the time of the transfer, XYZ Partnership did not have a section 754 election in effect. Immediately after the transfer, X's outside basis was $12 million and share of inside basis was $2 million. If XYZ Partnership had a section 754 election in effect at the time of the transfer, XYZ Partnership would have adjusted X's share of inside basis under section 743(b). Assume that the adjustment under section 743(b) would have resulted in a basis increase to Property 1 of $10 million. In a taxable year that is within two years[4] of the transfer of the partnership interest to X, XYZ Partnership makes a current distribution of Property 1 to X. Under section 732(a)(1), X's adjusted basis in Property 1 is zero. However, X makes an election under section 732(d) to adjust the basis of Property 1 to the adjusted basis it would have if the adjustment under section 743(b) were in effect with respect to the partnership property at the time X acquired its interest. As a result of the election under 732(d), because the adjusted basis of Property 1 under section 743(b) with respect to X would have been increased by $10 million, X takes a basis in Property 1 equal to $10 million and claims depreciation deductions based on a $10 million basis in Property 1.

[4] IRC § 732(d) grants a two-year window after the transfer of a partnership interest for a transferee-distributee partner to secure a basis adjustment as if the § 754 election had been in effect for the year of the transfer.

c. The IRS will not be shy about applying the economic substance doctrine to related-party basis adjustment transactions involving consolidated group partnerships and partners. Rev. Rul. 2024-14, 2024-28 I.R.B. 18 (6/17/24). This revenue ruling clarifies that the IRS may apply the "economic substance doctrine" of § 7701(o) to disallow tax benefits (such as increased cost recovery deductions, reduced gain, or increased loss) arising from related-party partnerships taking advantage of inside and outside basis adjustments (particularly in the consolidated return context). Recall that § 7701(o)(5)(A) defines the economic substance doctrine as "the common law doctrine under which tax benefits . . . with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose." Further recall that § 7701(o)(1) generally treats a transaction as having economic substance only if "(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction." Achieving a financial accounting benefit is not considered a valid "purpose" (within the meaning of § 7701(o)) if the origin of such financial accounting benefit is a reduction of Federal income tax. *See* § 7701(o)(4). Under § 7701(o)(5)(D), a "transaction" (within the meaning of § 7701(o)) includes a series of transactions. Finally, § 7701(o)(2)(A) provides that if a taxpayer relies on profit potential to prove a transaction has economic substance, the potential profit will be considered probative "only if the present value of the reasonably expected pre-tax profit of the transaction is substantial in relation to the present value of the expected net tax benefits" otherwise allowable. Rev. Rul. 2024-14 describes three different scenarios in the consolidated return context in which partnerships owned and controlled by members of the consolidated group either make (i) liquidating distributions of property under § 732(b) or (ii) engage in contributions or distributions (via partnerships with selective § 754 elections in effect) to obtain basis adjustments in contributed or distributed property under §§ 734(b) or 743(b). The corresponding basis adjustments to property held within the consolidated group provide enhanced tax benefits (i.e., increased cost recovery deductions, reduced gain, or increased loss) to the group. Importantly, however, Rev. Rul. 2024-14 stipulates two critical facts in this regard: (1) previous "contributions, distributions, and allocations" to partnerships held within the consolidated group "were undertaken intentionally with a view to creating" future inside/outside basis adjustments and (2) the purported financial "cost savings" (i.e., profit potential) from subsequent in-kind partnership contributions and distributions vis-à-vis the consolidated group members are "insubstantial in relation to the reduction in the aggregate Federal income liability" of the group. *Talk about loading the dice!* Rev. Rul. 2024-14 then unsurprisingly concludes that all three "basis shifting" scenarios lack economic substance, thereby allowing the IRS to disallow any enhanced tax benefits claimed by the consolidated group as a result of the transactions.

d. Proposed regulations under § 6011 identify certain related-party partnership basis adjustments as "transactions of interest" subject to heightened disclosure rules and penalties. REG-124593-23, Certain Partnership Related-Party Basis Adjustment Transactions as Transactions of Interest, 89 F.R. 51476 (6/17/24). Treasury has proposed regulations, to be contained in new Reg. § 1.6011-18, that would identify partnership related-party basis adjustment transactions such as those described above, and substantially similar transactions, as "transactions of interest," a type of "reportable transaction" (as such terms are defined in Reg. § 1.6011-4). Related parties for this purpose are those persons described in §§ 267(b) (without regard to the attribution rules of § 267(c)(3)) or § 707(b)(1). In general, then, related parties for this purpose include the following: members of a person's family (siblings, spouse, ancestors, lineal descendants); certain trust grantors, fiduciaries, and beneficiaries; certain estates, executors, and beneficiaries; and more-than-50-percent-controlled corporations and partnerships. Generally, taxpayers participating in these types of transactions are required to file special disclosures with the IRS under § 6011(a). *See also Form 8886, Reportable Transaction Disclosure Statement*. Material advisors (as defined) to such participating taxpayers also are subject to special disclosure and list maintenance requirements under §§ 6111(a) and 6012(a). *See also Form 8918, Material Advisor Disclosure Statement*. In addition, affected taxpayers and their material advisors are potentially subject to special penalties for failure to properly disclose, and for participating in, such transactions. See §§ 6662A; 6707; 6707A; 6708. Fortunately, perhaps, Prop. Reg. § 1.6011-18 will include a $5 million minimum threshold requirement such that only transactions involving a $5 million or greater basis adjustment in a taxable year are subject to the special disclosure and penalty provisions. Prop. Reg. § 1.6011-18 is slated to become effective as of the date final regulations are published in the Federal Register. For further analysis of Prop. Reg. § 1.6011-18, see New York State Bar Association Tax Section, Report on Proposed Regulations Regarding Partnership Basis Adjustments and Application of Notice 2024-54 to Previously Effected Transactions, Report #1498 (Aug. 16, 2024).

F. Partnership Audit Rules

G. Miscellaneous

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

B. Charitable Giving

1. After 2022, syndicated conservation easements are on life support if not DOA. A well-hidden provision of the SECURE 2.0 Act, Division T, Title VI, § 605 of the Consolidated Appropriations Act, 2023, amended Code § 170(h) to add a new subsection (7) severely restricting charitable deductions for "qualified conservation contributions" by partnerships, S corporations, and other pass-through entities. "Qualified conservation contributions" are defined by § 170(h)(1) to include (but are not limited to) conservation easements granted to charitable organizations in connection with syndicated conservation easements. As described in Notice 2017-10, 2017-4 I.R.B. 544, a typical syndicated conservation easement involves a promoter offering prospective investors the possibility of a charitable contribution deduction in exchange for investing in a partnership. The partnership subsequently grants a conservation easement to a qualified charity, allowing the investing partners to claim a charitable contribution deduction under § 170.

New "2.5 times" proportionate outside basis rule will limit the charitable deduction for conservation contributions by pass-through entities. New § 170(h)(7)(A) generally provides that a contribution by a partnership is not treated as a qualified conservation contribution (and therefore no deduction is allowed)—whether via a direct contribution or as an allocable share from a lower-tier partnership—if the amount of the contribution exceeds "2.5 times the sum of each partner's relevant basis" in the partnership. The term "relevant basis" is defined by new § 170(h)(7)(B)(i) to mean that portion of a partner's "modified basis" which is allocable (under rules similar to those used under § 755) to the real property comprising the qualified conservation contribution. "Modified basis" (defined in § 170(h)(7)(B)(ii)) essentially refers to a partner's outside basis exclusive of the partner's share of partnership liabilities under § 752. Thus, reading between the lines and subject to further guidance, relevant basis appears to equate to an investor's cash investment (a/k/a initial tax and book capital account) in a syndicated conservation easement partnership. Many syndicated conservation easement partnerships claim that investors may secure a charitable deduction that is five times their cash investment. New § 170(h)(7)(A) thus limits the charitable deduction to "2.5 times" an investor's cash contribution, making a syndicated conservation easement much less attractive. New § 170(h)(7) also contains three exceptions: (i) partnerships making conservation easement contributions after a three-year holding period applicable at the partnership- and partner-level, including through tiered partnerships; (ii) "family partnerships" (as defined) making conservation easement contributions; and (iii) partnerships making conservation easement contributions relating to historic structures. *See* IRC §§ 170(f)(19), 170(h)(7)(C)-(E). Moreover, new § 170(h)(7)(F) authorizes Treasury to issue regulations applying similar rules to S corporations and other pass-through entities. Related provisions of the legislation make dovetailing amendments to (i) § 170(f) (charitable contribution substantiation and reporting requirements); (ii) §§ 6662 and 6664 (underpayment penalties attributable to valuation misstatements); (iii) § 6011 (reportable transactions); and (vi) §§ 6235 and 6501 (statute of limitations). New § 170(h)(7) applies to qualified conservation contributions made by partnerships and other pass-through entities after December 29, 2022.

Some welcome news for non-syndicated conservation easement donors? In an uncodified provision (*see* § 605(d)), the legislation directs Treasury to publish "safe harbor deed language for extinguishment clauses and boundary line adjustments" relating to qualified conservation contributions (whether via partnerships or otherwise). Treasury is directed to publish such safe harbor deed language within 120 days of the date of enactment of new § 170(h)(7) (i.e., by April 28, 2023), and donors have 90 days after publication of the safe harbor language to execute and file corrective deeds. This special, uncodified relief provision seems to be targeted toward donors like those who lost battles with the IRS over highly technical language in their conservation easement deeds. *See* *Oakbrook Land Holdings LLC v. Commissioner*, 154 T.C. 180 (5/12/20) (deed's extinguishment clause violated the proportionate benefit rule), *aff'd*, 28 F.4th 700 (6th Cir. 3/14/22), and *Pine Mountain Preserve, LLLP v. Commissioner*, T.C. Memo. 2018-214 (12/27/18) (deed improperly allowed substituted property), *rev'd in part, aff'd in part, and vacated and remanded*, 978 F.3d 1200 (5th Cir. 10/22/20). Importantly, however, the foregoing uncodified relief provision does not apply to syndicated conservation easements as described in Notice 2017-10 or to conservation easement cases (and related penalty disputes) docketed in the federal courts before the date a corrective deed is filed.

a. Safe harbor conservation easement deed language published by the IRS with a short (now passed) deadline to file amended deeds. Notice 2023-30, 2023-17 I.R.B. 766 (4/10/23). As directed by Congress, the IRS has published safe harbor deed language for extinguishment and boundary line adjustment clauses relating to conservation easements.

Extinguishment Clauses. *Section 1.04* of the notice sets forth the IRS's litigating position with respect to extinguishment clauses in conservation easement deeds. The IRS's litigating position is that, upon destruction or condemnation of conservation easement property and the collection of any proceeds therefrom, Reg. § 1.170A-14(g)(6)(ii) (the "extinguishment regulation") requires the charitable donee to share in the proceeds according to a "proportionate benefit fraction" set forth in the conservation easement deed. (Keep in mind, however, that the validity of the extinguishment regulation has been called into question. The Eleventh and Sixth Circuits have reached opposite conclusions regarding whether Treasury and the IRS complied with the Administrative Procedures Act in promulgating the regulation. *Compare* *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir.

12/29/21) (extinguishment regulation invalid) *with Oakbrook Land Holdings, LLC v. Commissioner*, 28 F.4th 700 (6th Cir. 3/14/22) (extinguishment regulation valid). Thus far, the Supreme Court of the United States has declined to resolve the circuit split. See *Oakbrook Land Holdings, LLC v. Commissioner*, ___ U.S. ___, 143 S. Ct. 626 (1/9/2023).) The IRS's view of the allowed language in the conservation easement deed has been fairly narrow, requiring that the proportionate benefit fraction be fixed and unalterable *as of the date of the donation* according to the following ratio: the value of the conservation easement as compared to the total value of the property subject to the conservation easement. Therefore, according to the IRS and as upheld by several court decisions, if the conservation easement deed either (i) allows the donor to reclaim from the charitable donee any portion of the donated conservation easement property in exchange for substitute property of equivalent value or (ii) grants the donor credit for the fair market value of subsequent improvements to the donated conservation easement property, the proportionate benefit fraction language in the deed is flawed and the charitable deduction must be disallowed. *See, e.g.*, *Pine Mountain Preserve, LLLP v. Commissioner*, 151 T.C. 247 (2018), including its companion case, *Pine Mountain Preserve, LLLP v. Commissioner*, T.C. Memo. 2018-214 (deed allowed substituted property), *aff'd in part, vac'd in part, rev'd in part*, 978 F.3d 1200 (11th Cir. 2020); *PBBM Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (2018) (deed reduced charitable donee's benefit for subsequent improvements made by taxpayer donor); *Coal Property Holdings, LLC v. Commissioner*, 153 T.C. 126 (2019). *Section 4.01* of Notice 2023-30 then sets forth what the IRS considers acceptable language regarding the proportionate benefit fraction as is relates to extinguishment clauses in conservation easement deeds.

Boundary Line Adjustment Clauses. *Section 4.02* of Notice 2023-30 provides sample boundary line adjustment clause language. Unlike the background discussion relating extinguishment clauses in conservation easement deeds, the notice does not explain why Congress determined that the IRS should publish sample boundary line adjustment clause language. The IRS acknowledges in Notice 2023-30 that "[n]either the Code nor the regulations specifically address boundary line adjustments."

Amendments. Section 3 of the Notice sets forth the process and timeline for amending an original "flawed" (in the eyes of the IRS) conservation easement deed to adopt the IRS-approved proportionate benefit fraction or boundary line adjustment language. Corrective, amended deeds must be properly executed by the donor and the donee, must be recorded by July 24, 2023, and must relate back to the effective date of the original deed.

b. Final regulations on the disallowance of deductions for conservation easements by partnerships and S corporations. T.D. 9999, Statutory Disallowance of Deductions for Certain Qualified Conservation Contributions Made by Partnerships and S Corporations, 89 F.R. 54284 (6/28/24). The Treasury Department and the IRS have finalized proposed regulations[5] under amended Code § 170(h)(7) and the related information reporting rule of Code § 170(f)(19). The final regulations apply to partnerships and S corporations that claim qualified conservation contributions and partners and shareholders to whom the contribution deduction is allocated. The final regulations provide guidance on the statutory disallowance rule of § 170(h)(7), definitions of terms, methods of calculating the "relevant basis" of a partner or an S corporation shareholder, three statutory exceptions, as well as other reporting requirements. The final regulations apply to qualified conservation contributions by pass-through entities (partnerships and S corporations). They do not apply to contributions by individuals or C corporations.

General rules. In general, under § 170(h)(7)(A), a contribution by a partnership (or S corporation) is not treated as a qualified conservation contribution if the amount of the contribution

[5] REG–112916–23, Statutory Disallowance of Deductions for Certain Qualified Conservation Contributions Made by Partnerships and S Corporations, 88 F.R. 80910 (11/20/23).

exceeds "2.5 times the sum of each partner's [or S corporation shareholder's] relevant basis" in the partnership or S corporation. Thus, if the amount of a contribution by a partnership or S corporation exceeds this limit, then no deduction is allowed. There are three statutory exceptions to this disallowance rule. One exception applies to contributions made three or more years after the later of (i) the last date on which the pass-through entity acquired any interest in the real property with respect to which the contribution is made or (ii) the last date on which any owner or upper tier pass-through entity acquired an interest in the pass-through entity that made the contribution. See § 170(h)(7)(C). The second exception is for contributions by family partnerships. See § 170(h)(7)(D). The third exception is for contributions to preserve certified historic structures. See § 170(h)(7)(E).

Relevant basis, modified basis. As discussed above, no deduction is allowed for a conservation contribution by a partnership or S corporation if the amount of the contribution exceeds 2.5 times the sum of each partner's or S corporation shareholder's relevant basis. The term "relevant basis" means the portion of a partner's "modified basis" in the partnership which is allocable (under rules similar to those of § 755) to the portion of the real property with respect to which the contribution is made. IRC § 170(h)(7)(B)(i). The term "modified basis" (defined in § 170(h)(7)(B)(ii)) essentially refers to a partner's outside basis exclusive of the partner's share of partnership liabilities under § 752.

Ultimate members. The final regulations use the term "ultimate member" and apply the statutory limit with reference to the relevant basis of a partnership's or S corporation's ultimate members. Specifically, the final regulations provide that no deduction is allowed for a conservation easement contribution by a partnership or S corporation if

> the amount of the qualified conservation contribution exceeds 2.5 times the sum of each of the contributing partnership's or contributing S corporation's ultimate member's relevant basis ….

Reg. § 1.170A-14(j)(2)(i). For this purpose, an "ultimate member" is any partner or S corporation shareholder that (i) is not itself a partnership or S corporation, and (ii) receives a distributive share or pro rata share, directly or indirectly, of a qualified conservation contribution. Reg. § 1.170A-14(j)(3)(x). Thus,

> ultimate members will either be partners holding a direct interest in a partnership, which may be the contributing partnership or an upper-tier partnership, or shareholders holding a direct interest in an S corporation, which may be the contributing S corporation or an upper-tier S corporation. Upper-tier S corporations and upper-tier partnerships themselves are not considered ultimate members.

Reg. § 1.170A-14(j)(3)(x). The regulations thus contemplate that a partnership or S corporation must identify its ultimate members and determine the sum of the relevant basis of each of those ultimate members.

Rules for tiered entities. The final regulations provide rules for tiered entities (partnerships and S corporations). Under these rules, an allocated portion (i.e., distributive share) of the contribution deduction received by an upper-tier entity is disallowed if either (i) the contribution is a disallowed contribution with respect to the entity (partnership or S corporation) that allocated the deduction to the upper-tier entity (partnership or S Corporation), or (ii) the allocated portion exceeds 2.5 times the sum of the upper-tier entity's ultimate member's relevant basis. Reg. § 1.170A-14(j)(2)(ii). In general, if a contribution deduction is disallowed for a lower-tier entity, then that contribution deduction is also disallowed for the upper tier entity that owns an interest in the lower-tier entity. However, if a contribution deduction is allowed for a lower-tier entity, then the same analysis moves to the next higher tier to determine once again whether the upper-tier entity has a disallowed amount. The test keeps getting reapplied at each tier up the entity chain.

Examples. The final regulations contain numerous complex examples that illustrate the application of the rules described above. While it is beyond the scope of this outline to review each of the examples, the following examples from Reg. § 1.170A-14(j)(6) illustrate the basic rules:

Example 1: Disallowed qualified conservation contribution.

(A) Facts. A, an individual, and B, a C corporation, form AB Partnership, a partnership for Federal income tax purposes. AB Partnership acquires real property. Two years later, AB Partnership makes a qualified conservation contribution with respect to the property and claims a contribution of $100X on its return. AB Partnership allocates the contribution equally to A and B. A's relevant basis is $30X, and B's relevant basis is $8X.

(B) Analysis. A and B are the ultimate members of AB Partnership because they each receive a distributive share of the qualified conservation contribution and are not partnerships or S corporations. The claimed amount of AB Partnership's qualified conservation contribution is $100X, which exceeds 2.5 times the sum of A's and B's relevant bases, which is $95X ($95X = 2.5 x (A's $30X relevant basis + B's $8X relevant basis)). Therefore, AB Partnership's contribution is a disallowed qualified conservation contribution. No person may claim any deduction with respect to this contribution, even though A's $50X distributive share of the contribution does not exceed 2.5 times A's $30X relevant basis.

Example 3: Tiered partnerships

(A) Facts. Individuals E and F form UTP Partnership, a partnership for Federal income tax purposes. UTP Partnership and G, a C corporation, form LTP Partnership, a partnership for Federal income tax purposes. LTP Partnership acquires real property. Two years later, LTP Partnership makes a qualified conservation contribution with respect to the property and claims a contribution of $100X on its return. LTP Partnership allocates the contribution $5X to G and $95X to UTP Partnership. UTP Partnership allocates its $95X portion of the contribution $45X to E and $50X to F. G's relevant basis is $10X, E's relevant basis is $11X, and F's relevant basis is $21X.

(B) Analysis for LTP Partnership. The ultimate members of LTP Partnership are G, E, and F because they each receive a distributive share of the qualified conservation contribution and are not a partnership or S corporation. Because UTP Partnership is a partnership, it is not an ultimate member of LTP Partnership, even though it receives a distributive share of the qualified conservation contribution. The amount of LTP Partnership's qualified conservation contribution is $100X, which does not exceed 2.5 times the sum of each of the ultimate member's relevant basis, which is $105X ($105X = 2.5 x (G's $10X relevant basis + E's $11X relevant basis + F's $21X relevant basis)). Therefore, LTP Partnership's contribution is not a disallowed qualified conservation contribution (that is, is not disallowed by section 170(h)(7) and this paragraph (j)) with respect to LTP Partnership and G.

(C) Analysis for UTP Partnership. Because UTP Partnership receives an allocated portion, UTP Partnership must apply this paragraph (j) and paragraphs (k) through (m) of this section to determine whether its allocated portion is a disallowed qualified conservation contribution. The ultimate members of UTP Partnership are E and F because they each receive a distributive share of UTP Partnership's allocated portion and are not partnerships or S corporations. The amount of UTP Partnership's allocated portion of LTP Partnership's qualified conservation contribution is $95X, which exceeds 2.5 times the sum of E's and F's relevant bases, which is $80X ($80X = 2.5 x (E's $11X relevant basis + F's $21X relevant basis)). Therefore, UTP Partnership's allocated portion of LTP Partnership's contribution is a disallowed qualified conservation contribution with respect to UTP Partnership, E, and F. No partner of UTP Partnership may claim any deduction with respect to this contribution, even though F's $50X distributive share of the contribution does not exceed 2.5 times F's $21X relevant basis. This does not affect the determination that G's distributive share of the contribution is not a disallowed qualified conservation contribution.

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

F. Liens and Collections

G. Innocent Spouse

H. Miscellaneous

1. **Here we go again as another front opens in the FUBAR-FBAR war, but the Eleventh Circuit's decision is only a pyrrhic victory for this particular taxpayer.** United States v. Schwarzbaum, ___ F.4th ___ (11th Cir. 8/30/24). Readers will recall that The Bank Secrecy Act provides in part that U.S. persons owning an interest in foreign accounts with an aggregate balance of more than $10,000 must file an annual disclosure report. *See* 31 U.S.C. 5314; 31 C.F.R. § 1010.306 (2021). The Financial Crimes Enforcement Network's ("FinCEN") Form 114 — Report of Foreign Bank and Financial Accounts ("FBAR") is used to file the report. Failure to properly file FinCEN Form 114 may result in varying penalties under 31 U.S.C. 5321(a)(5), depending upon whether the failure was willful or non-willful. The penalty for willfully failing to file an FBAR disclosure is severe: the greater of $100,000 or 50 percent of each offending account per year. Due to the severity of the FBAR penalty for willfully failing to file, an Eighth Amendment Excessive Fines Clause issue has been lurking beneath the surface of the litigated cases. The Excessive Fines Clause of the Eighth Amendment to the U.S. Constitution states, "Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted." U.S. Const. amend. VIII. The U.S. Court of Appeals for the First Circuit in *United States v. Toth*, 33 F.4th 1 (1st Cir. 2022) held (as explained further below) that FBAR penalties for willful failure to file are remedial, not punitive, in nature. In other words, the penalty safeguards the U.S. fisc by reimbursing the IRS and Treasury for the time and expense of investigating and uncovering a taxpayer's circumvention of U.S. tax laws. Because the nature of the willful FBR penalty is remedial, not punitive, the First Circuit determined that the penalty is not a "fine" subject to scrutiny under the Excessive Fines Clause of the Eighth Amendment. After the First Circuit's decision in *Toth*, the U.S. Supreme Court denied certiorari to review the court's holding. *See Toth v. United States*, 143 S. Ct. 552 (1/23/23). One might have thought that the U.S. Supreme Court's denial of certiorari in *Toth* settled the matter; yet, in this case, in an opinion by Judge Marcus, the Eleventh Circuit agreed with the taxpayer that the Eighth Amendment's Excessive Fines Clause applies to willful FBAR penalties. As explained in detail below, however, the taxpayer's victory in the Eleventh Circuit was a pyrrhic one, as the court held that only $300,000 of a total of $12.5 million in FBAR penalties sought by the IRS were "excessive" within the meaning of the Eighth Amendment's Excessive Fines Clause. Regardless of the extent of the taxpayer's success before the Eleventh Circuit in *Schwarzbaum*, the court's holding that the Excessive Fines Clause applies to limit willful FBAR penalties creates a clear split with the First Circuit. Thus, notwithstanding the U.S. Supreme Court's decision in *Bittner v. United States*, 598 U.S. 85 (2023), in which the Court held that *non-willful* FBAR violations are subject to a maximum

penalty of $10,000 regardless of the number of accounts the taxpayer falls to disclose, and its denial of certiorari in *Toth*, the Supreme Court may not be out of the FUBAR-FBAR war just yet.

Background of Schwarzbaum. The facts and procedural history of *Schwarzbaum* are somewhat complicated. The taxpayer was a wealthy German and U.S. citizen with multiple foreign bank accounts. Specifically, the taxpayer had seventeen Swiss and four Costa Rican bank accounts from 2006-2009. Accordingly, the taxpayer was required to file FBAR reports concerning his foreign accounts. The taxpayer filed a few FBAR reports for 2008 and 2009 but did not disclose all of his foreign bank accounts. Then, in 2010, the taxpayer's IRS troubles began in earnest when he finally reported all of his foreign bank accounts for the first time in connection with the IRS's Offshore Voluntary Disclosure Initiative ("OSVDI"). The taxpayer later opted out of the OSVDI program for unknown reasons. An IRS investigation of the taxpayer's foreign bank accounts ensued, and litigation followed in the U.S. District Court for the Southern District of Florida (Judge Bloom). After some procedural ups and downs (including a prior appeal to the Eleventh Circuit[6]), Judge Bloome upheld the IRS's imposition of roughly $12.5 million in *willful* FBAR penalties against the taxpayer for 2007-2009. The taxpayer subsequently appealed (*again!*) to the Eleventh Circuit.

Eighth Amendment Excessive Fines Clause Appeal. The taxpayer argued before the Eleventh Circuit that the IRS's imposition of approximately $12.5 million in FBAR penalties across his foreign accounts for 2007-2009 violated the Excessive Fines Clause of the Eighth Amendment. The taxpayer urged the Eleventh Circuit to conclude, contrary to *Toth*, that the FBAR penalties for willfully failing to disclose foreign bank accounts are punitive, not remedial. Therefore, the taxpayer argued, willful FBAR penalties are "fines" subject to the Eighth Amendment's Excessive Fines Clause. The IRS, of course, argued as it had in *Toth* that FBAR penalties are remedial—like other federal tax penalties intended to safeguard the fisc and reimburse the IRS and Treasury for the time and expense of investigating and uncovering circumvention of U.S. tax laws.

Eleventh Circuit Declines to follow Toth. Judge Marcus wrote the opinion on behalf of the Eleventh Circuit. After reviewing precedent interpreting the Excessive Fines Clause and surveying the legislative history of the FBAR regime, Judge Marcus reasoned: "The Government can impose a $1,000,000 penalty on a $2,000,000 account regardless of whether the Government spent a million dollars investigating the case or whether it spent nothing at all, or any number in between." ____ F.4th at ____. Judge Marcus also reasoned that, based upon precedent, a civil penalty such as that in the FBAR statute need only be *partially* punitive to be subject to the Excessive Fines Clause.[7] Declining to follow *Toth*, Judge Marcus concluded: "No matter how you cut it, it's apparent that [the FBAR penalty] statute is designed to inflict punishment at least *in part* . . . . We

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[6] The taxpayer has had several battles with the IRS, some of which have been discussed in prior versions of these materials. *See United States v. Schwarzbaum*, 24 F.4th 1355 (11th Cir. 2022) (vacating and remanding for penalty redetermination *United States v. Schwarzbaum*, 125 A.F.T.R.2d 2020-2109 (5/18/20). *See also United States v. Schwarzbaum*, 125 A.F.T.R.2d 2020-1323 (S.D. Fl. 3/20/20) (bench trial opinion).

[7] In this regard, although the U.S. Supreme Court denied certiorari in *Toth*, Justice Gorsuch dissented from the Court's refusal to hear the case, writing of the First Circuit's opinion:

> This decision is difficult to reconcile with our precedents . . . . The government did not calculate [the FBAR] penalty with reference to any losses or expenses it had incurred. The government imposed its penalty to punish [the taxpayer] and, in that way, deter others. Even supposing, however, that [the taxpayer's] penalty bore both punitive and compensatory purposes, it would still merit constitutional review. Under our cases a fine that serves even "*in part* to punish" is subject to analysis under the Excessive Fines Clause.

143 S. Ct. at _____ (emphasis in original). In *Schwarzbaum*, Judge Marcus's opinion relied in part upon Justice Gorsuch's above-quoted dissent as support for the Eleventh Circuit's conclusion that willful FBAR penalties are subject to the Excessive Fines Clause of the Eighth Amendment.

hold, therefore, that the FBAR penalty is a fine subject to the Eighth Amendment's Excessive Fines Clause." ____ F.4th at ____ (emphasis added).

Account-by-Account Analysis: Having concluded that the willful FBAR penalty is a "fine" subject to the Eighth Amendment's Excessive Fines Clause, the Eleventh Circuit next had to determine whether the FBAR penalties asserted against the taxpayer in this case were "excessive." The Eleventh Circuit rejected the taxpayer's argument that the Excessive Fines Clause analysis should focus on the taxpayer's total FBAR penalties for 2007-2009. Instead, Judge Marcus wrote that the court must determine, *on an account-by-account basis*, whether the asserted FBAR penalties are "grossly disproportional" to the balances in the taxpayer's offending accounts across each of the years 2007-2009. *See United States v. Bajakajian*, 524 U.S. 321 (1998) (a punitive forfeiture of currency in a U.S. customs matter violates the Excessive Fines Clause if it is "grossly disproportional" to the gravity of the offense). Judge Marcus's opinion includes a comparison chart listing the taxpayer's offending accounts from 2007 through 2009. The chart, reproduced below, compares the taxpayer's maximum account balances (where known), June 30 balances (the FBAR due date for the years in issue, but now April 15), and the maximum allowable penalty per account per year.[8]

Bank Account	**Maximum Balance (Prior Calendar Year) ($)**	**June 30 Balance ($)**	**Maximum Statutory Penalty ($)**
2007			
Aargauische	15,809	11,872	100,000
UBS 6308	1,988,799	8,615,602	4,307,801
UBS 9250	15,022,514	(5,571)	100,000
UMB	672,185	*Unknown*	100,000
Scotiabank de Costa Rica 0588	*Unknown*	*Unknown*	100,000
2008			
Aargauische	13,487	10,601	100,000
Bank Linth	2,605,399	*Unknown*	100,000
BSI	3,880,596	*Unknown*	100,000
Clariden Leu	3,712,704	4,106,132	2,053,066
Raiffeisen	3,101,437	3,137,728	1,568,864
St. Galler	3,353,964	*Unknown*	100,000
UBS 6308	8,615,602	*Closed*	100,000
UBS 9250	15,630,205	*Closed*	100,000
UMB	672,185	*Unknown*	100,000
Scotiabank de Costa Rica 0588	*Unknown*	*Unknown*	100,000
Scotiabank de Costa Rica 1472	*Unknown*	*Unknown*	100,000
2009			
Aargauische	15,758	9,966	100,000
Banca Arner	3,096,278	3,078,492	1,539,246

[8] Notice that the maximum allowable FBAR penalty potentially assessable against the taxpayer according to Judge Marcus's chart (roughly $13.5 million) exceeds by about $1 million the FBAR penalty the IRS actually asserted in the case (roughly $12.5 million). Judge Marcus explained that the IRS asked the District Court to forgo the $1 million difference, and although the taxpayer attempted to argue that this was improper and triggered a statute of limitations question, the Eleventh Circuit ruled that it was permissible for the IRS to seek less than the maximum allowable FBAR penalty.

Bank Account	Maximum Balance (Prior Calendar Year) ($)	June 30 Balance ($)	Maximum Statutory Penalty ($)
Bank Linth	2,955,271	*Unknown*	100,000
BSI	4,311,494	*Unknown*	100,000
Clariden Leu	4,374,222	4,504,702	2,252,351
Raiffeisen	3,139,508	*Closed*	100,000
St. Galler	4,267,212	*Unknown*	100,000

What Is "Excessive"? After setting forth the above chart, Judge Marcus's opinion examines the annual balances in each account to compare the balances against the maximum permissible FBAR penalties—a facts and circumstances analysis. Unfortunately for the taxpayer, Judge Marcus's facts and circumstances analysis concludes that only one account ("Aargauische") suffered "grossly disproportional" FBAR penalties in violation of the Excessive Fines Clause of the Eighth Amendment. A total of $300,000 in FBAR fines ($100,000 per year) were associated with the Aargauische account, but the account never had more than about a $16,000 balance throughout 2007-2009. Judge Marcus determined that a fine "over six times the greatest amount ever held in the account" is excessive. ____ F.4th ___. As for the rest of the taxpayer's accounts and associated FBAR penalties, Judge Marcus found that the penalties asserted were not "grossly disproportional" within the meaning of the Excessive Fines Clause. Summarizing, Judge Marcus wrote: "Going account by account, we are not persuaded that any of the remaining fines—even those taking fifty percent of an account in a given year—are excessive as applied to [the taxpayer]." ___ F.4th at ___. Lastly, after rejecting several procedural challenges raised by the taxpayer, the Eleventh Circuit remanded the case to the District Court to enter a judgment against the taxpayer for approximately $12.2 million in willful FBAR penalties ($300,000 less than initially determined by the IRS and the District Court) plus late fees and interest for the years 2007-2009.

Comment: In our view, even if one agrees with the result, Judge Marcus's Excessive Fines Clause analysis in this willful FBAR penalty case leaves much to be desired. The account-by-account, facts and circumstances analysis employed by the Eleventh Circuit provides no guiding principles or measuring rules (other than the "grossly disproportional" standard) for resolving future willful FBAR penalty cases. Theoretically, any taxpayer residing outside the First Circuit, especially those within the Eleventh Circuit, may challenge the IRS's imposition of willful FBAR penalties under the Eighth Amendment's Excessive Fines Clause. Presumably, outside the First Circuit, the IRS will be left to exercise its discretion regarding the "proportionality" of any willful FBAR penalty it asserts, hoping that the penalties imposed eventually will be sustained by the courts against an Excessive Fines Clause challenge.

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

XIII. TRUSTS, ESTATES & GIFTS